# MARKET COMMENTARY

## Financial implications of “Operation Epic Fury”

GenAM, Macro and Market Research

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- **The stated rationale for the attack is clear, but the end target less so, making it harder to forecast economic and financial fallouts. The US and Israel are likely (realistically) aiming at a recalibration of the Iranian regime, rather than a full overhaul: the latter (stated objective) would entail a lengthy and politically costly stepping up of military involvement. Iran’s capabilities have been hit hard but can still inflict severe damage to global energy flows.**
- **Our base scenario envisages a rather limited escalation, with only a temporary (4-5 weeks) disruption of oil and gas flows from the Gulf, which would cost no more than 0.3pp to the euro area 2026 GDP. Risks are naturally tilted towards a longer lasting and more disruptive confrontation, but both the US (elections) and China (fossil energy imports) have a vested interest in ending the conflict sooner rather than later. In the worst-case scenario, a two-quarter halt to most of the Gulf oil supply would lead prices to above $120/bbl, knocking off around 0.8% pp of growth in Europe and pushing up inflation by nearly one and a half percentage point.**
- **The US dollar has returned to its status of haven, for now – thanks to the heavy military and energy focus in this crisis. Government bonds have not. The rise in bond yields partly reflects inflation fears, while the rising real yields echo our warning that surging public debt has reduced the safe-haven status of Govies. Still, we would use yield spikes – above 4.30% in 10y Treasuries – to add duration.**
- **Defence stocks are benefiting, and US equities outperforming the EU, more crowded recently and exposed to energy imports. In our base scenario of a contained crisis, the equity drawdown will be a buying opportunity in the coming weeks. Yet we recommend diversifying a cyclical overweight with defensive sectors and inflation hedgers. Likewise in EUR Credit, spread widening will offer opportunities; we recently downgraded Financials, and our preferred hedge is working indeed, with iTraxx subordinated financials underperforming.**

After the surprise attack by US and Israel on Iran and the strong retaliation, uncertainty remains high. To explore the possible fallouts, a good starting point is to consider the US/Israel's aims and Iran's possible responses. Officially, the objective is to change the Iranian regime. Historically, this has never been achieved by air strikes, without “boots on the ground”. **A complete regime change thus appears particularly unlikely before upcoming elections** (later October in Israel, early November in the US). President Trump is calling for the Iranians to heroically topple the regime. Easier said than done, as the strength of the Iranian power structure lies in its networks, inside and outside, such as Hezbollah in Lebanon and Houthis in Yemen.

The recent military strikes have left Iran with limited but impactful options. **Its strategy is centred on increasing the cost of the war for the US and its allies, including GCC countries**. Iran is thus trying to regionalize the conflict. Though its navy cannot fully blockade Hormuz, even minor attacks could disrupt oil and gas shipping. Iran might also target oil and civilian infrastructure, especially in places like Dubai, and use Houthi forces in Yemen to attack vessels in the Red Sea. The 2024 offensive halved Suez Canal transit, showing how disruptive low-tech tactics can be.

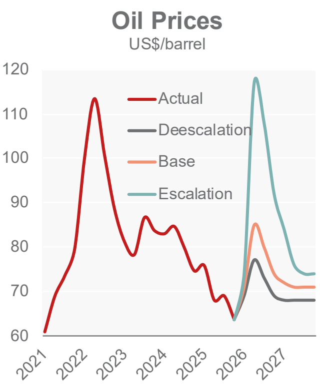
**For now, a more realistic objective may be to pressure Iran's leadership to comply with US demands**. The quick reopening of oil flows would also please China, largely dependent on fossil energy from the Gulf. There is our base case: war for a few weeks. We see the risks on both sides. On the downside, Iran's leadership may be much less likely to make costly concessions, and the killing of top officials could lead to a chaotic transition. We develop three scenarios:

• **Base**: Iran keeps retaliating, reducing oil and gas flows to Asia and Europe. Domestic pressure pushes the US to negotiate an uncertain truce. Brent jumps to $85 and gas prices rise further in Europe.

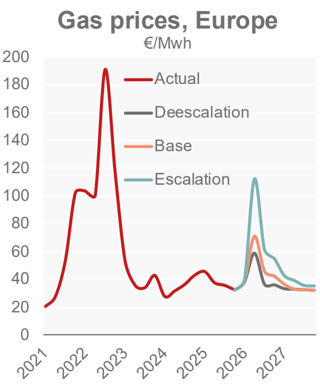
• **De-escalation**: A new or reformed Iranian government quickly reaches a deal with the US, giving up nuclear ambitions, and restores Hormuz access. Oil briefly very spikes to $80/bbl, then falls below $70; gas disruptions are minimal. Of course, this positive scenario may have different shades, depending on the type of regime transition (status quo, rapprochement, or sharper turn towards democracy).

• **Escalation**: Iran blocks Hormuz and severely damages GCC oil infrastructure, cutting OPEC+ supply. Gas to Europe and Asia is heavily restricted, Suez Canal traffic slows. Energy prices remain high, oil nears $120, and European gas prices spike to half the peak seen during the Ukraine war. A partial agreement eventually removes the gridlock, but a political risk premium remains baked in energy prices.

In the quick de-escalation scenario, the short duration of the crisis implies an extremely limited economic fallout. In the base scenario, global economic impact is mild: we would shave 0.2-0.3 pp from our solid Euro area GDP forecast, with Asia hit by a similar or superior amount, while the impact on US GDP should not exceed 0.2pp. In the extreme scenario, euro area activity drops by 0.8 pp, US by 0.6 pp.



*Source: Oxford Economics, GenAM*



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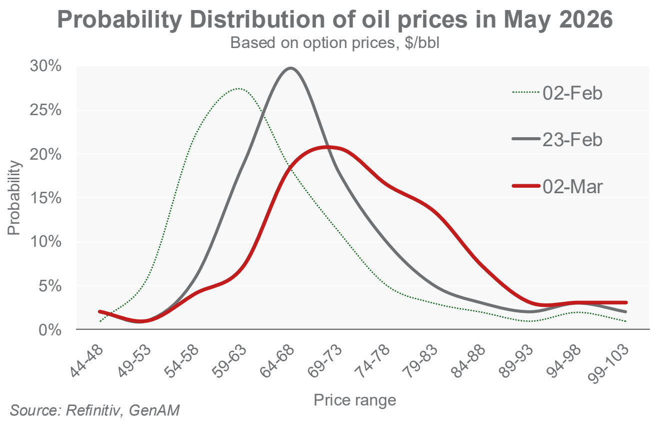


*Source: Refinitiv, GenAM*

**The economy.** The Iran war will hit the euro area economy just as recovery signs were strengthening, in both actual GDP growth (modestly) and forward-looking surveys (more forcefully), including in manufacturing. Should the conflict persist, a stagflation shock would develop, putting our 1.4% growth forecast for 2026 at risk. The US economy appears less exposed, given energy self-sufficiency: the major risk is that a protracted conflict (and extreme scenario) would further dampen household consumption and prevent a broadening of the capex cycle.

Faced with a stagflationary shock, **central banks** have few options; they can look through if oil prices spike briefly, but second-round effects could force rate hikes longer term, and further damage the growth cycle. While the potential inflationary impact in the euro area is significant, the recent slide of inflation to just below target leaves the ECB comfortable in keeping rates at current levels in case of a controlled and temporary increase in energy prices. The market is still pricing nearly two Fed cuts this year, still one too many, in our books. We see signs of strain in supply chains, not just in energy, which makes a quick normalisation of inflation even less likely.

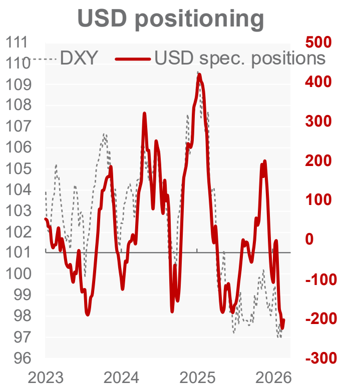
**Government bonds** failed to show a sustained safe-haven response on Monday and have even declined amid geopolitical escalation. The notable drop in bond yields in February – despite stable fundamentals and somewhat hawkish central-bank communication – is being partly reversed, with 10-year US Treasury yields jumping above 4.0%, and 10-year Bund above 2.70%. The yield outlook now hinges on political and military developments. Lasting or further increases in energy prices could lift yields through higher inflation expectations; a significant disruption to energy infrastructure or transport routes would likely push front-end inflation breakevens higher. The growth-dampening effects of geopolitical tensions exert downward pressure on real yields, but fiscal concerns create an opposite force.

Provided the global growth impact remains contained, we do not expect a quick return to last week's yield lows. This aligns with historical patterns: geopolitical shocks – particularly those involving energy supply risks – typically coincide with rising yields, rather than flight to safety-induced declines. Only a broad risk-off phase would lead to downward pressure on yields. We **keep duration close to neutral**. Our bias was for slightly higher yields, but recent angst about the impact of AI on the labour market had led us to reduce the short. **We would use yield spikes – say above 4.30% in 10y Treasuries – to add duration.**

**Fixed Income spreads**. The moderate rise in credit spreads in February accelerated a bit on the war. IG and HY corporate spreads, EM hard currency spreads, and non-core euro area sovereign spreads all moved moderately higher, though without signs of panic selling. This may largely reflect the fact that oil prices had already incorporated a significant geopolitical risk premium, rising more than 20% between late December and late February. A further escalation could still push spreads wider in the coming days. However, given the constructive macro backdrop, a sustained widening trend appears unlikely in our base case. We maintain a fundamentally positive stance toward spread products, recommending that investors **selectively buy the dips**. At the same time, caution is warranted toward issuers that would be directly affected by further escalation – especially net-energy importing countries and energy intensive corporates.

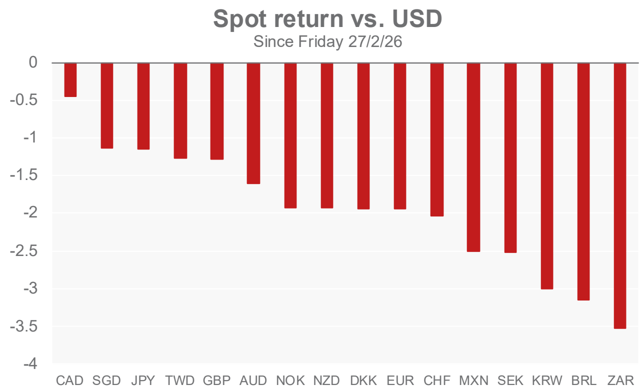
**More specifically, in EUR credit**, we maintain our sector allocation, which remains broadly balanced between large defensive sectors and selected cyclical ones. **Recently, we downgraded financials** due to their connection with the private credit space. Traditionally, CDS indices have shown greater reactions than cash, and more in EUR than USD (economy less exposed to surging energy costs). However, we believe euro credit is generally more resilient, especially in a stagflationary environment, and prefer to buy the dip here. Additionally, our preferred hedge is performing well, with iTraxx subordinated financials underperforming.

**Currencies**. The US dollar is benefiting from the war in the Middle East, in sharp contrast to last year's 'Liberation Day' when the USD's safe-haven appeal was severely questioned. The key difference is that current geopolitical escalation is mostly about energy prices and security. Interventions in Venezuela and Iran give the US better control of the global oil complex, which will matter for upcoming discussions with China. The US has become a net exporter of oil thanks to the sharp increase of shale production. US consumers will feel the pain of rising gasoline prices, but the overall economy is largely insulated from the energy shock. By contrast Europe and Japan are net importers and high energy price are raising import bills and deteriorating their terms of trade to the detriment of their exchange rates. In fact, the EUR took the strongest hit on reports that there had been attacks on oil facilities in the Gulf. A prolonged conflict would likely keep the recovery potential for the EUR/USD largely capped while a further escalation of the war and another leg up in the oil price may boost the USD further in the short term, as short dollar positions are unwound (left chart below). A quick end to the conflict would help both EUR and JPY to recover more swiftly also thanks to cyclical optimism and persistent efforts to diversify USD exposure amid the more challenging US policy backdrop. The volatility skew shows that the bullish euro consensus has vanished. **There is still near-term downside in EUR/USD, but 1.15 would be a buying opportunity in our central case.**



*Source: ICE, CFTC, Bloomberg, GenAM*

*Source: Refinitiv, GenAM*



*Source: Bloomberg;GenAM*

**Equities**. Investors have obviously favoured defensive assets since the inception of the war. Europe has underperformed the US, as it is more cyclical and a net importer of oil and gas. EU Banks, Consumer Services, Airlines, Construction, Luxury, and Household sectors have underperformed, while Energy, Defence, Telecoms, Pharma, Metals, and Food have outperformed.

In our central scenario where uncertainty gradually abates and both inflation and medium-term macroeconomic prospects are only marginally affected, we see reasons to remain overweight equities. That said, **diversification** remains key: we maintain a **cyclical tilt while also including defensives such as Pharma, Utilities, and Telecoms alongside Gold and other inflation hedges**:

these assets can perform well even in a ceasefire scenario (with Defence, Utilities, and Materials/Metals more resilient than Energy), as elevated fiscal spending and structural commodity scarcity are likely to persist.

Before the Iran war started, we had maintained an overweight position in equities, albeit a reduced one following the strong performance of recent months. We would buy the dip on an extension of the risk-off phase. History shows that, on average, similar geopolitical "frictions" have not had a lasting impact on equity performance, Middle East episodes included. On a 3-month horizon, best sectors have been financials, telecoms and energy. Worst: staples and discretionary.

| Average 3-month performance after Middle East / war events | | EU sectors |
|---|---|---|
| **worst avg** | **0.8** | **Cons. Durables** |
| 2nd worst | 3.9 | Autos |
| 3rd worst | 5.7 | Food, Beverages and Tobacco |
| 4th worst | 5.8 | Household and Pers.Products |
| 5th worst | 7.1 | Comm./Prof. Services |
| | | |
| **DJ Stoxx 600** | **4.3** | |
| | | |
| **best avg** | **18.0** | **Div. Financials** |
| 2nd best | 15.7 | Utilities |
| 3rd best | 14.8 | Insurance |
| 4th best | 11.7 | Telecommunication Services |
| 5th best | 11.7 | Energy |

*Source: Datastream, GenAM calculations*