

Middle East conflict: Peak stress lies ahead

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In our earlier update, we cautioned that energy prices, bond yields, and the US dollar would likely move higher before any resolution of the Middle East conflict. We now appear to be approaching peak escalation, increasing the likelihood of a sharp rise in oil prices in the weeks or months ahead before conditions begin to stabilize.

Our scenario dashboard from the summer envisioned a delayed resolution lasting several months, with oil averaging \$90-\$100 in the second half of 2026. That forecast has largely played out, with oil averaging \$92 between 1 July and 15 October. We now believe this scenario is approaching its natural end state.

	Downside (80%) – Delayed resolution	1979 redux (20%)
Description	Diplomacy and low-intensity conflict drag on for weeks or months until US or Iranian concessions materialize.	Mutual distrust sustains kinetic conflict, causing substantial damage to energy infrastructure before an eventual deal.
Energy flow	Gradual deterioration in energy supply through year-end.	Prolonged shock to crude and refined oil supply.
Macro	Energy supply-side stress weighs on global growth but does not disrupt the cycle.	Global stagflation shock weighs on most risk assets.
Q4 2026 average oil price	Oil: \$100-\$110	Oil: >\$120

Geopolitics: Why escalation risks are rising

Since the initial US-Iranian MoU fell apart in July, the US has reimposed an economic blockade on Iran, while Iran has attacked commercial shipping around Hormuz. In practice, however, oil flows have picked up materially as the US has repeatedly targeted Iranian anti-ship radar and launch sites along the southern coast.

Even with oil above \$100, an adequately supplied global crude market remains a tolerable status quo for the US. Moreover, key US allies in the Gulf, Saudi Arabia and the UAE, are coping financially, with Saudi oil revenues roughly flat and UAE revenues higher than in 2025 (Figure 2).

However, this is incompatible with Iranian

oil revenues being sharply curtailed and its economy under severe strain. Iran needs to break the current setup and will therefore continue to ramp up its attacks. First and foremost, it is likely to intensify efforts to disrupt shipping through Hormuz. Second, it could use its proxies in Iraq and coordination with Yemen's Houthis to inflict economic pain on Gulf countries, including through attacks on energy infrastructure. Third, if these measures fail to materially alter the outcome, Iran could resort to a more direct assault on the region's energy complex. Across all three scenarios, energy supplies face increasing disruption risks, suggesting oil prices should remain elevated in the absence of conflict resolution.

Beyond the US-Iran dynamic, the Yemen conflict has its own drivers that threaten critical energy supplies. Without US-Iran de-escalation, the incentives for the Houthis to target Saudi energy facilities remain high. Energy markets have largely priced in higher transportation costs and intermittent supply disruptions but continue to assume these will not develop into a broader supply shock. Markets also appear to assume that oil prices will fall significantly once the war ends. That assumption is looking increasingly questionable given the Houthis' entrenched position.

Macro: Pathways to a supply squeeze remain the same

The familiar risks of a larger global macro shock from an oil crisis persist. To recall, this has so far been avoided through three key buffers: demand compression, notably in China; inventory releases; and the rerouting of supply via the Red Sea and Gulf of Oman. All three are now fading.

Alternative supply routes face the risk of

missile attacks, inventory drawdowns are reaching their limits, and speculation is growing that China could resume higher oil imports. Stress in refined products also remains more acute than in crude oil. Taken together, these pressures increase the upside risks to global inflation and monetary policy tightening.

Markets: Conflict adds to bond stress and cycle headwinds

Although the recent jump in G7 bond yields was not war-related, higher yields could make market conditions increasingly sensitive to disruption (Figure 3). The question is how this could affect AI capex spending. With macro activity and market performance increasingly concentrated around the AI capex cycle, any disruption to spending could have wider knock-on effects. Large-scale debt financing is also becoming a feature of the next leg of the cycle, making this feedback loop more pronounced. In this context, another rise in oil prices coinciding with higher interest rates would give the war-driven inflation impulse greater significance than it had in the spring.

Investment implications

- We are nearer the endgame, with another oil price spike expected before de-escalation sets in. This implies not only higher oil prices, but also higher short-term rates than previously priced and a stronger near-term US dollar.
- The tactical case for duration becomes worth considering if rates reach levels restrictive enough to slow AI capex. That is not the case yet.
- For equities, a punitive rate environment argues for a higher defensive allocation, coupled with selective exposure to winners from the AI infrastructure buildout.

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are more volatile than bonds or short-term instruments. Government bonds and corporate bonds generally have more moderate short-term price fluctuations than stocks, but provide lower potential long-term returns. U.S. Treasury Bills maintain a stable value if held to maturity, but returns are generally only slightly above the inflation rate.

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