MIDDLE EAST CONFLICT – INVESTMENT IMPLICATIONS

*By **Cedric Scholtes***
Head of Investment Team, Global Sovereign, Inflation and Rates
April 2026

Cedric Scholtes
Head of Investment Team, Global Sovereign, Inflation and Rates

In this article we discuss recent events in the Middle East and highlight the scenarios and macroeconomic implications outlined by our research Team. The purpose is to provide a framework for analysing the investment implications of the war in Iran.

As the reader will be aware, the United States and Israel launched military strikes against Iran on February 28th, bringing negotiations to a close. Although Israeli and US objectives likely differ, several weeks of air strikes have sought to:

(i) Remove Iran's senior leadership and pressure any successor regime to be more compliant.

(ii) Degrade Iran's conventional military capabilities, with particular focus on Iran's ballistic missiles and drones.

(iii) Destroy Iran's nuclear enrichment and development of military applications and potentially remove materials.

(iv) End Iran's ability to instruct, supply and finance various proxy groups, like the Houthis in Yemen and Hezbollah in Lebanon, as well as Hamas in the Palestinian territories.

(v) Provide the conditions for a popular uprising to achieve regime change.

(vi) Reopen the Straits of Hormuz to permit renewed transit of crude oil, liquefied natural gas and various distillate products.

The US and Israel have so far had mixed results, with the Iranian regime having demonstrated an ability to fight on through asymmetric means despite heavy losses in its leadership ranks and materiel. Although the number of ballistic missile launches have diminished, Iran continues to send cheap drones against Israel, US bases and Gulf countries, and has effectively closed the Straits of Hormuz to maritime trade. Application of heavy bombardment by the US and Israel, and repeated threats of escalation have failed to bring the Iranians to heel, with the warring parties remaining seemingly too far apart in their (public) demands to envisage an immediate ceasefire.

Financial markets have been especially focused on the near total closure of the Straits of Hormuz, which has brought shipments of crude oil, distillates, liquefied natural gas, fertilizers and various chemicals to a near standstill, and forced severe throttling of production given limited local storage. In addition, the broadening of target lists by both sides to include Iranian and Gulf energy infrastructure is also particularly concerning, given that damaged facilities could require months, even years of repairs. The result has been to drive energy prices sharply higher, with WTI and Brent near-dated crude oil

futures climbing to above $100 and $110 per barrel, respectively. Oman and Dubai-traded crude oil futures climbed higher still, climbing to over $150 pb in mid-March. Dutch Natural gas futures, meanwhile, rose from EUR 31 / MWh in February to a peak of EUR 67 / MWh.

Energy prices have likely been capped by President Trump's assurances that the conflict would stick to its 4 to 5-week initial timeline, the removal of sanctions on Russian and Iranian oil (to reduce global shortages), the opening of 400mm barrels of strategic oil reserves by IEA members, the rerouting of some crude supplies via pipeline to the Red Sea, and by Iran's decision to allow some tankers from non-aligned countries to transit the Straits of Hormuz. But financial markets remain on edge, uncertain as to the magnitude and duration of production and supply disruptions over coming weeks, which will determine the path for energy prices, with implications for inflation, growth.

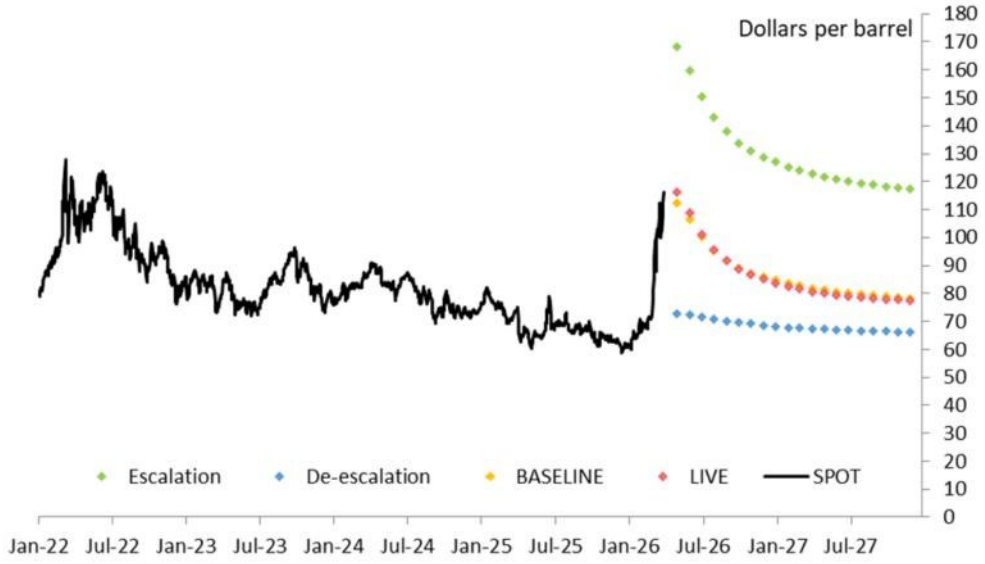
Correspondingly, our research team has developed three scenarios for energy prices, which we can use to then draw out implications for likely policy responses. These three scenarios are:

(i) A Baseline scenario in which the conflict is relatively short-lived, and energy prices evolve in line with energy futures curves as per March 20th, which is characterized by a peak of $110 pb in front-month crude oil futures, with the curve then in contango and declining to around $80 pb a year out.

(ii) An Escalation scenario, in which the conflict timeline is extended and / or regional energy infrastructure is damaged, generating a sustained period of supply disruptions and elevated prices lasting for months. The Macro Team assumes this drives energy prices higher by 50% versus the baseline futures curve. Still, the futures curve remains in contango, indicating a gradual easing of prices. Note, however, that although this is a large oil shock, one could envisage an even more persistent disruption if the war escalated into…

(iii) A De-escalation scenario in which oil prices would quickly return to pre-conflict levels. One could reasonably argue that this scenario is no longer achievable – that the cumulative shortfall of traffic through the Strait of Hormuz and damage to oil infrastructure during the war means that oil prices are unlikely to fall back to these levels even if peace is declared as you read this note. However, we view this assumption as a sensible "no war" reference point.

Exhibit 1: Conditioning assumptions for Scenarios: Oil futures



Sources: Bloomberg, BNPP AM, March 2026

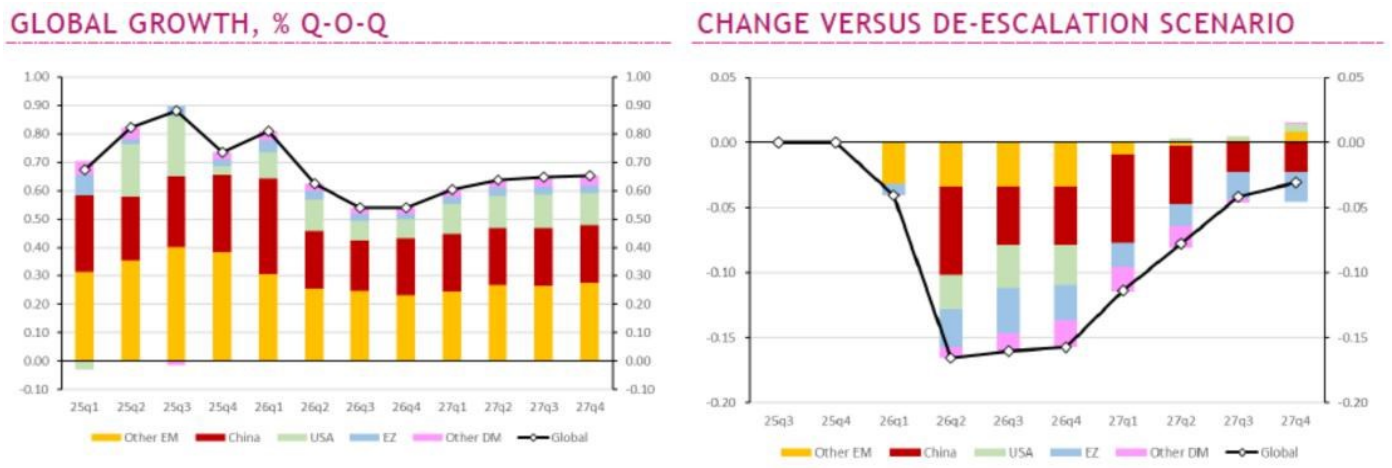
Finally, as portfolio managers, we would add that it is worth contemplating a fourth scenario, which we would call the Catastrophe scenario, in which the United States and Iran war escalated to such a degree that Middle East energy extraction, refining and distribution facilities were so comprehensively damaged that at least a third of the region's energy output would be offline for months, if not years. In such a scenario, oil prices could extend beyond $150 pb and stay there for a year.

In any case, our research team can then model the macro implications of their scenarios for growth, inflation and policy rates. The main conclusions of their analysis are as follows:

- An energy supply shock reduces global growth. The baseline scenario reduces global growth projections versus the prior forecast by around $^1/_4$ ppt over the year to 2027 Q2. To put this number in context, a rule of thumb is that a 10% increase in oil prices knocks around 0.1ppt off growth – although economists tend to worry that this figure is stale, for all DM economies (which have become less energy intensive over time, so oil is losing its power to shock) and particularly for those countries that produce energy (where there is a countervailing boost to investment in energy extraction when oil prices rise).

- In the Escalation scenario, global growth is reduced by 0.6 ppt to 2027 Q2, with European growth reduced by around 1 ppt. However, the team highlights that elevated uncertainty would reduce business and household confidence and worsen growth prospects further. The counterargument is that a large energy shock would likely trigger a substantial fiscal response, in which case the forecasts would look different, particularly if governments resorted to price controls to suppress inflation. But fiscal easing would then likely transfer, via higher deficits and issuance, to higher yields in the bond market.

The direct growth impact of the Escalation scenario versus the de-escalation scenario is illustrated below:

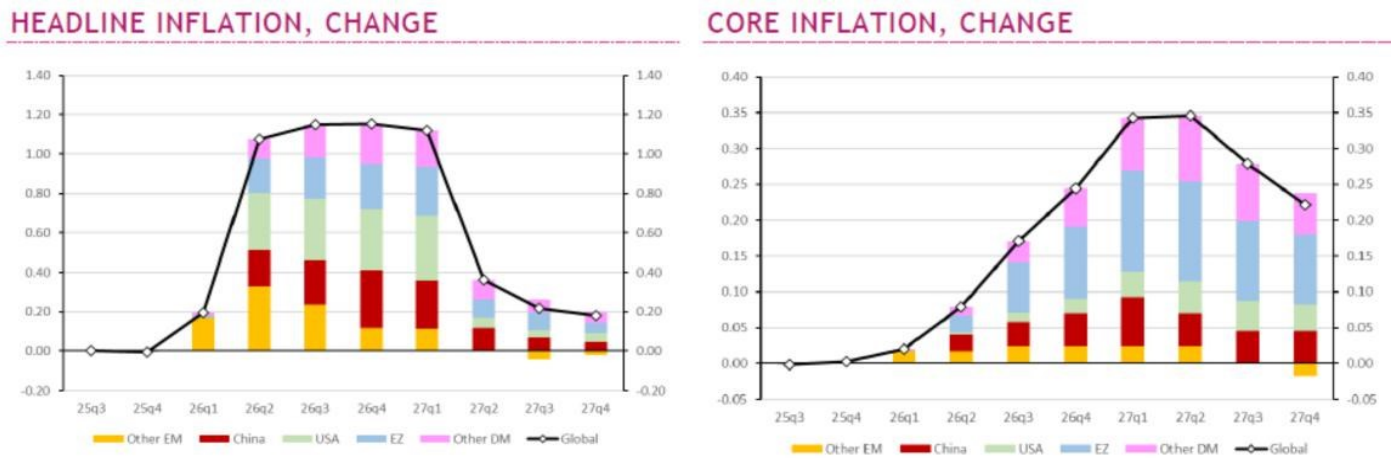


Source: BNPP AM, March 2026

Turning to prices and inflation, an energy shock implies a jump in headline inflation. Higher wholesale energy prices lead to higher retail energy prices with a short lag: petrol prices go up and then utility bills go up – unless governments intervene to cap prices. Economists disapprove of these price controls because they remove the incentive for people to adjust their behavior, but politicians sometimes disagree (e.g. the Japan forecast does assume retail energy price caps).

- Once again, it is worth repeating that petrol prices go up a lot at the very start of the forecast, and then start coming down, and by the middle of 2027, petrol prices will be lower than a year before, pulling down on inflation. In the meantime, the initial surge in energy prices is gradually feeding through supply chains into the price of other items in the consumption basket: food, non-energy industrial goods and services. Taken together with direct effects on petrol and utility bills, these price increases are known as the "first-round effects" of an energy shock, and they will largely materialize before the horizon where changes in monetary policy today can have a major effect on inflation. If that was all that happened, then you could reasonably describe the impact as "transitory" – in fact, if energy prices follow the futures curve down, the situation is even better than that, because inflation would be lower further into the future (i.e., some of the price level news unwinds).

- In an Escalation scenario, at the global level, inflation is now close to 120bp higher over the next year than would have been the case without the war. Inflation does fall back in 2027 (where energy starts to have a negative direct effect) but core inflation is now around 1/3pp higher in mid-2027 slowing the fall-off in headline inflation. The impact of the Escalation Scenario versus the De-escalation scenario is illustrated below



Source: BNPP AM, March 2026

The cause for concern is "second-round effects": rising prices erode the living standards of workers who push for higher wages, and those higher wages than squeeze the margins of companies who respond by raising prices. This wage-price spiral can transform a one-off increase in the level of energy prices into a persistent increase in the rate of inflation. Monetary policy 101 says central banks must prevent these second-round effects from kicking in.

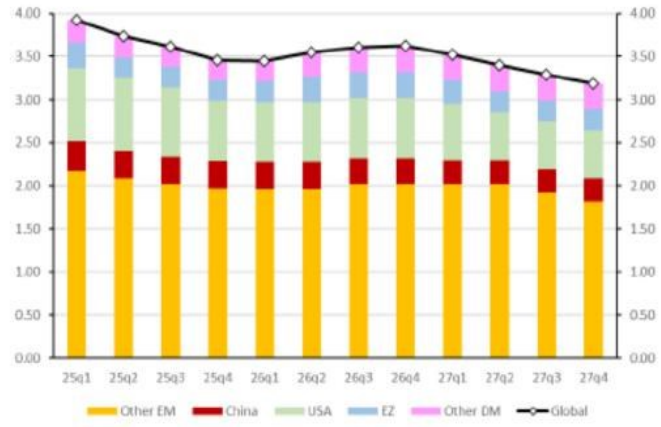
In their forecasts, the research team make the critical **assumption that there are no significant second-round effects.** This may seem like a brave assumption given the inflationary episode we have just experienced, but we think it is a reasonable one because second-round effects are likely state-contingent, as opposed to a mechanical process. True: there are indexation clauses in a few places, which automatically link wage settlements to inflation no matter what state the economy is in. Otherwise, wages are the result of some bargaining process with unions or set by companies – but in either of these cases, the outcome will reflect the state of the economy. The Research team argues that labor markets are generally looser than following the pandemic, and AI is a new threat to job security. The Research Team **also assumes there is no large-scale fiscal stimulus** underpinning demand, which is likely to further weigh on labor demand.

Rationing of energy is not formally modelled in the Escalation scenario, but a shock on this scale would likely lead to some significant increases in prices where production is effectively constrained. And we still do not assume major second-round effects, even with this much larger increase in prices and implicit squeeze on real incomes. From this perspective, the risks around the core inflation profile are likely skewed to the upside. Equally, if the risks to activity mentioned above materialize – and the associated increase in unemployment was more severe – then that would put more downward pressure on core inflation at the end of our forecast and into 2028.

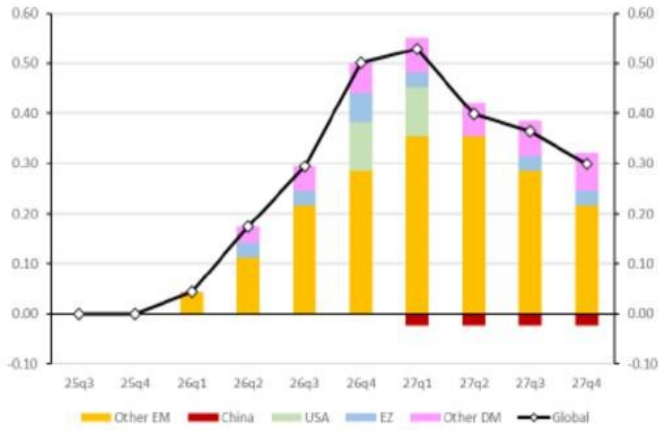
Turning to monetary policy, in the Baseline scenario, if central banks were sure that second-round effects would not kick in, then it would not be unreasonable to leave rates on hold. But central banks cannot be sure. What they can be sure of is that inflation will rise in the short run, households will notice and will tend to revise up their expectations of inflation accordingly. Central banks will also be acutely aware of the reputational damage that was done by the recent inflationary episode. On this basis, the Research Team see many (but not all) central banks responding to the energy shock. At peak, our representative global policy rate is one hike (25bp) higher.

In the Escalation scenario, the central bank response is correspondingly larger. Rather than creating a pause in the easing trend in our baseline scenario, the representative global policy rate is almost exactly two hikes (50bp) higher than would have been the case in the absence of the war. Once again, this adjustment is rapid – before central banks can be confident about the size of the output and second-round effects of the shock. By the end of 2027 around half of that increase has been unwound. The impact on policy rate path is highlighted below.

POLICY RATE, %



CHANGE VERSUS DE-ESCALATION SCENARIO



Source: BNPP AM, March 2026

It is worth re-emphasizing, however, that the research team assumes governments resist from engaging in large-scale fiscal intervention to compensate firms and households for the energy price shock. In an Escalation or Catastrophe scenario, the political pressure to intervene could be overwhelming, and the implication of a negative energy supply shock being met with a positive fiscal demand shock would be to drive policy rates and broader interest rates significantly higher.

Cedric Scholtes
Head of Investment Team, Global Sovereign, Inflation and Rates

Cedric Scholtes is Head of Global Sovereign, Inflation and Rates. He also acts as Chair of the Rates Committee. He is responsible for the growth and development of Inflation Strategies, and is the lead portfolio manager for US Inflation-Linked Bond portfolios, as well as US Treasury portfolios.

Cedric chairs the Rates Committee, which is composed of specialists from different fixed income product groups, who are charged with generating alpha in sovereign, derivative and inflation markets for implementation across applicable portfolios.

Cedric joined FFTW, a predecessor of BNP Paribas Asset Management, in 2006 as a portfolio manager and is based in Paris.

Cedric joined the firm from the Treasury trading desk at Goldman Sachs, where his responsibilities included taking proprietary positions and market-making in index-linked markets, as well as enhancing the desk's analytical capabilities. Prior to working at Goldman Sachs, Cedric spent five years at the Bank of England, two of which were spent on secondment to the Federal Reserve Bank of New York. At the Bank of England, Cedric spent two years in the Foreign Exchange Division, helping to manage the UK Treasury's foreign exchange reserves. Prior to that, he worked as a Research Economist within the Monetary Analysis Division, researching fixed income markets. Cedric has published articles on nominal and inflation-linked debt markets in Bank of England, BIS and IMF periodicals, as well as RiskBooks.

Cedric has 21 years of investment experience. He holds an MSc in Finance and Economics from Warwick Business School, an MSc in Economics from the London School of Economics, and an MA/BA in Economics from Cambridge University.

DISCLOSURES

Opinions expressed are current as of the date appearing in this document only. This document is confidential and may not be reproduced or redistributed, in any form and by any means, without BNPPAM USA's prior written consent.

"BNP PARIBAS ASSET MANAGEMENT" is the global brand name of the BNP Paribas group's asset management services. The individual asset management entities within BNP PARIBAS ASSET MANAGEMENT if specified herein, are specified for information only and do not necessarily carry on business in your jurisdiction. For further information, please contact your local BNP Paribas asset manager.

This document is provided for your reference on a private and confidential basis to discuss an existing or potential advisory relationship. You are invited to meet with BNPPAM USA to discuss any of the information provided herein or otherwise, including any and all terms (including fees) that may apply to the relationship.

This document is not to be construed as an offer to buy or sell any financial instrument. It is presented only to provide information on investment strategies and current financial market trends. The analyses and opinions contained in this document are those of BNPPAM USA, and are based upon information obtained by BNP PARIBAS ASSET MANAGEMENT USA, Inc. from sources which are believed to be reliable. BNPPAM USA provides no assurance as to the completeness or accuracy of the information contained in this document. Statements concerning financial market trends are based on current market conditions, which will fluctuate. Investment strategies which utilize foreign exchange may entail increased risk due to political and economic uncertainties. The views expressed in this document may change at any time. Information is provided as of the date indicated and BNPPAM USA assumes no duty to update such information. There is no guarantee, either express or implied, that these investment strategies work under all market conditions. Readers should independently evaluate the information presented and reliance upon such information is at their sole discretion.

BNP PARIBAS ASSET MANAGEMENT USA, Inc. is registered with the US Securities and Exchange Commission as an investment adviser under the Investment Advisers Act of 1940, as amended.