

Middle East Conflict: Market Volatility Increases



Following the attacks on Iran and the subsequent retaliatory strikes across the region financial markets have understandably become more volatile. Energy shares have gained, airline stocks have declined, and both gold and the US dollar have strengthened. Meanwhile, bond yields are balancing safe-haven demand with rising inflation expectations. Despite the current uncertainty, the most probable scenario is a swift de-escalation, allowing market volatility to ease.

On the final day of February, the United States and Israel carried out coordinated strikes on Iranian military and missile facilities after nuclear negotiations stalled. Iran responded with attacks across Israel and several Gulf states, prompting widespread airspace closures and disruption around the Strait of Hormuz — a critical oil chokepoint.

Around one-third of global crude production is concentrated in the Middle East, and close to 20% of worldwide oil consumption passes daily through the Strait of Hormuz. Iran's leverage is as much geographic as it is military, and financial markets typically begin pricing in perceived supply risks well before any physical shortages emerge.

The escalation comes at a time when investors were already cautious. In the weeks prior to the strikes, markets experienced volatility driven by disruption in AI-related software and lingering concerns about the scale of capital expenditure being committed to AI with uncertain returns. In short, markets were already nervous as they reflected a more uncertain environment.

In recent weeks, both oil and gold had been trending higher, while the US dollar has strengthened, as negotiations stalled around Iran's nuclear capabilities. There were two main objectives to the bombing of Iran: preventing Iran from acquiring a nuclear weapon and destroying its missile arsenal and production sites - alongside a desired political outcome of regime change from within.

However, bond yields have largely moved sideways, as they balance the flight to safety trade on one hand but the expectation of energy-led inflation on the other. Ordinarily, a sharp rise in risk aversion would push yields materially lower. However, the spike in oil prices could also signify higher inflation, which would push yields higher. In the context of the last 2 weeks of trading, US 10-year yields remain much the same.

Investors are considering three possible outcomes to the current escalation. One possible path is that hostilities continue in a contained and measured way - similar to how the war in Ukraine persists but has limited day-to-day impact on global asset prices. A second scenario would involve sustained disruption to oil flows, with tangible effects on physical supply. That outcome could weigh on growth and complicate the ability of the Federal Reserve to deliver further rate cuts.

The most widely held view, however, is that severe disruption is unlikely given Iran's dependence on oil revenues. Iran does rely heavily on oil exports for state revenue, and a prolonged or total closure of the Strait of Hormuz would also damage Iran economically. Because of this self-harm risk, many analysts argue Iran prefers limited or temporary disruption rather than a sustained shutdown.

The most probable outcome therefore appears to be rapid containment, with diplomatic efforts limiting further escalation and shipping flows normalising quickly. Under this scenario, volatility would decrease and markets would revert to their typical baseline level of risk.

Geopolitical flare-ups inevitably unsettle investors, especially when equity markets respond with sharper volatility. However, the right course of action does not change: stay disciplined and focused on a well-diversified portfolio built around long-term goals. While the escalation in the Middle East and the potential disruption to oil supplies have prompted both stock and bond markets to reprice risk, most analysts view the impact as temporary.

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