

Oil price crisis and market volatility – Key opinion changes

Key Messages

1. Given the events of the past week, we have decided to integrate the risk of a prolonged Iranian conflict into our recommended asset allocation.
2. With crude oil prices breaching USD 100/barrel as of Monday 9 March, we will enter the realm of oil demand destruction if these elevated oil and gas prices persist over the next few months, as was the case in 2022. Uncertainty over this conflict remains very high, reflected in the jump in implied volatility on oil, stocks and FX markets over the past week.
3. Such a stagflationary economic scenario leads us to take a **more prudent view on risk assets**, notably both global equities, the high yield credit as well as emerging bond markets.
4. We downgrade Corporate High Yield to Negative and Emerging Market bonds to Neutral. We downgrade Equities to Neutral (we have maintained a Positive stance since late 2022). Within regions, we downgrade Japan and Emerging Markets to Neutral (but more cautious on Asia). We downgrade Europe to Negative. Sector-wise, US Financials are downgraded to Negative and Europe Financials to Neutral.
5. We see less potential for dollar weakness and change our 3-month target to USD 1.14 and also revise our 12-month target to USD 1.20 (value of one euro).

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The risk of high oil prices for longer

The Brent **crude** oil price surged to above USD 100 per barrel on Monday, up over 70% year-to-date. The military conflict between the US/Israel and Iran has escalated further and seems unlikely to end soon.

The effective closure of the Strait of Hormuz is worse than we had forecast in our initial scenario. Furthermore, due to tanker traffic disruption and attacks on oil production and refining facilities, several Gulf states are temporary halting or reducing their oil and gas production. Thus, this supply disruption is real, and production could take longer than initially expected to return to pre-conflict levels. There is no evidence that US/Israel or Iran are ready to negotiate or de-escalate. Even if President Trump blinks (due to pressure from markets and from Gulf state allies), will the Iranians allow the Strait of Hormuz to reopen to seaborne traffic?

Given the likeliness of ongoing supply disruption for some more weeks, we now take into account a higher average Brent crude price of close to USD 100 per barrel for this month. Further spikes to USD 120 or higher are not excluded if the attacks on oil installations escalate or if the Strait remains closed for longer. Once there is some perspective on de-escalation, oil and gas prices could quickly pull back. But our initial scenario of Brent returning to its USD 60–70 trading range before year-end has become less realistic, as the original oversupply will now be absorbed by current temporary production outages. So, a more realistic 12-month target would be a range of USD 70–80, still far below current levels.

Economic growth and inflation – Risk scenario more likely

The economic consequences of higher oil prices depend not only on the magnitude of the increase but also on the price level and, especially, on the duration of the energy shock. A price level above USD 100 — and in particular above USD 120 — for more than two months would dramatically raise the probability of a recession, even in the United States. Regarding inflation, energy commodities account for roughly 3% of the consumer price index (CPI) inflation and about 2% of the personal consumption expenditures (PCE) deflator, so headline inflation would be directly affected. Core inflation is different because the index excludes energy and food items. It would require a sustained period of rising oil prices to push core inflation up persistently via secondary effects, which is unlikely even in this alternative scenario. Consequently, central banks are expected to look through this potential rise and are unlikely to raise policy rates. Keep in mind that such a scenario would probably trigger a recession and a sharp increase in the unemployment rate. Therefore, interest rate cuts are more likely in the alternative scenario.

The US economy is relatively insulated from global oil price movements. Although the shock would erode real consumer incomes, it could nevertheless bolster GDP growth by stimulating capital expenditure in domestic oil production. The United States has only recently become a net energy exporter, which is an advantage. While gas imports from the Middle East are modest, Europe remains vulnerable to rising energy prices, and the accompanying sentiment shock could extinguish its fledgling economic momentum. Moreover, defence and infrastructure programmes are highly energy intensive, so the fiscal multiplier could diminish if energy prices stay elevated.

For emerging economies, a sustained high oil price typically translates into stagflation — low growth combined with high inflation.

Consequently, divergent paths are likely for growth and external account performance. Large energy exporters such as Colombia and Brazil are expected to be the most sheltered, whereas net energy importers like South Korea, India, and the broader CEEMEA region appear the most vulnerable.

Less potential for dollar weakness

The US dollar has benefitted from safe-haven flows in the context of this current oil price shock. We expect only one Fed rate cut later this year, leaving the interest rate differential relatively wide. As mentioned on the following page, we are downgrading our opinion from Neutral to Negative for eurozone Equities while keeping the opinion Neutral on the US. This reflects a deterioration in the relative expected return of eurozone versus US equities. Accordingly, we have adjusted our EUR/USD outlook: we have changed our 3-month target to USD 1.14 and have also revised our 12-month target to USD 1.20 (value of one euro). Indeed, the risk premium linked to expanding fiscal deficits driven by mid-term election-related spending remains a concern and could sustain pressure on the dollar once the oil crisis resolves.

More caution regarding corporate high yield and emerging market bonds

Our positive stance for emerging market bonds in local currency was based on two key arguments: i) the outlook for a weaker dollar and ii) the potential for central banks in emerging countries to lower rates as inflation was expected to fall further. The risks related to these two factors have been rising and the risk return trade-off is no longer attractive, thus justifying a downgrade to Neutral.

We also downgrade our opinion on corporate high yield bonds to Negative. The risk-return trade-off has deteriorated further as the outlook for weaker issuers is more at risk while spreads have only risen moderately.

Time to trim risks

The risks of a prolonged conflict causing a more sustainable rise in energy prices increased over the weekend. The selection of Mojtaba Khamenei as new supreme leader does not seem to indicate that the Iran is ready to end hostilities. Thus, we see increasing risks for growth expectations in regions that are most dependent on energy imports. Moreover, higher energy costs will have short-, and potentially, long-term impacts on consumption as they act as an additional tax.

This comes at a time when we see further cracks in the US private credit market. Should higher inflation cause a sustainable rise in yields, the pressure on already stressed assets might intensify. In a worst-case scenario this might create a negative spillover effect in the broader financial system and the economy.

The risk-reward picture for equities has deteriorated during the last week. The situation might well become materially worse before it gets better. To reflect those risks we **downgrade our global equity view to Neutral**.

Regional changes

The tailwinds for **emerging markets** are at the risk of fading. Rates might not fall as much as expected, the dollar is strengthening and the closing of the Strait of Hormuz poses a key risk to energy supply, especially for Asia. Over 80% of the Oil & LNG exports via the Strait usually go to Asia. We therefore **downgrade Emerging Market equity to Neutral**. Within Emerging Markets, we **turn underweight Asia (except for China which we rate as Neutral)** but remain **overweight Latin America** as the region benefits from higher energy prices.

LNG imports account for up to 40% of **Europe's** total energy imports, leaving Europe directly exposed to a longer-lasting rise in LNG prices. We expect that the business and consumption climate will take a hit as this would echo the experience of 2022. Europe tends to underperform during oil price shocks (Table 1). We thus **downgrade Europe to Underweight**.

Japan is another large net energy importer. Rising geopolitical tensions in combination with slower global growth should limit the upside for Japanese equities, especially given their elevated valuations. We therefore downgrade Japan to Neutral. The USA are now a net exporter of energy. Thus, the net effect on growth might even be slightly positive, albeit a huge dispersion in sector performance is to be expected. **We remain Neutral**.

Sector changes

Higher oil and gas prices threaten global growth, especially for sectors like autos, travel, leisure, and consumption stocks. Earlier this year, we shifted energy to Neutral and suggested more focus on oil equipment & services. Short-term winners include Western fertilizer producers and metals that are essential for electronic warfare amid supply disruptions and geopolitical instability. Many industrial sub-sectors remain appealing due to increased Western defence and infrastructure spending.

Growth slowdowns hurt low-rated and private credits, evident from increased redemptions from private credit and equity funds. The worsening geopolitical climate reduces confidence and liquidity; as a result, we **downgrade US Financials to Underweight** and advise avoiding riskier financial stocks. **In Europe, while less exposed to private markets, we downgrade Banks and Financial Services to Neutral**, noting that cheap valuations and strong balance sheets may not protect against further market declines or weaker earnings.

If tensions ease, hard-hit sectors — particularly consumer discretionary, select banks, and basic materials — could see a sharp recovery, as the US administration responds to market and inflation pressures.

TABLE 1: OIL PRICE SHOCKS HAVE A STRONGER EFFECT ON EUROPE

Event	Start (Peak)	End (Trough)	Duration (Days)	Perf. SPX (%)	Perf. SXXP (%)	Oil Change (%)
1st Iraq war (1991)	24.12.1990	16.01.1991	23	-5,4%	-6,8%	18,2%
2nd Iraq war(2003)	14.01.2003	12.03.2003	57	-14,2%	-21,5%	18,5%
Libya Airstrikes (2011)	18.02.2011	10.08.2011	173	-18,6%	-24,8%	23,1%
Ukraine-Invasion	04.01.2022	12.10.2022	281	-24,5%	-21,3%	45,8%
Strikes on Houthis in Yemen (2024)	02.01.2024	02.02.2024	31	-2,1%	-3,5%	16,8%
Epic Fury	28.02.2026	?	9	-2,0%	-7,1%	44,5%
		Average	113	-11,1%	-14,2%	

Source: BNP Paribas, Bloomberg



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