Middle East Conflict Intensifies

- After U.S. bombings of nuclear sites in Iran, investors are patiently monitoring for further escalations.
- Investor responses have been somewhat muted, but this could change quickly.
- Typically, geopolitical events are short-term market events and staying invested is usually rewarded.

With the U.S. bombing some of Iran's nuclear sites over the weekend, uncertainty in the Middle East conflict is growing. Investors do not like uncertainty as it clouds economic outlooks and earnings forecasts. When futures markets opened on Sunday evening, U.S. equities were only modestly lower, and bonds were slightly higher. Commodities, such as gold and oil, were also positive but not signaling a crisis event. Initial investor reaction was measured as they wait to see if Iran retaliates and further escalates the conflict.

While history doesn't always repeat, sometimes it rhymes. Conflicts in the Middle East are unfortunately not a new phenomenon. What we typically see initially during times of war or conflict in the Middle East are rising oil prices, falling stock prices and a surge in safe haven buying in investments such as bonds and gold. The U.S. dollar also tends to do well in these scenarios. While no one knows what will happen this time, this investment picture seems reasonable.

Iran has said its next move may be to close the Strait of Hormuz or attack U.S. interests abroad. If it does close the Strait of Hormuz, this would send oil prices higher. It is estimated that around 20% of global oil and liquified natural gas consumption passes through this strait daily. If the oil and gas can't make it through this strait, supply will fall significantly and push up oil and gas prices. The good news is that many intelligence and commodity experts expect the strait to remain open, as much of the oil leaving it is Iranian oil headed to China. Pressure from the world's two largest countries could reverse any closure. The strait is also used to import food to the Middle East. Closing the strait could also be seen as an act of war against neighboring countries in the region. The impact of a closure to the United States would be limited. Perhaps for these reasons, oil prices have been somewhat contained even with the threat of closure. A broader escalation of the conflict, however, could impact oil prices, so investors will be watching this closely.

As we mentioned in our previous X post, geopolitical events tend to be short-lived in markets. For investors, this means they should stay focused on their long-term goals and objectives. Markets can be volatile as investors digest new information, but over the longer-term, markets tend to rebound quickly. Abandoning long-term objectives by getting out of the market after a sell-off and missing the rebound can set back investment goals.

In these times of uncertainty, we stress diversification in portfolios. Diversification can help smooth returns by not having too much exposure to any one risk. Some stocks will likely outperform during a Middle East conflict and, like we mentioned before, bonds may also do well. We are not saying change your allocation to these sectors, but instead owning these sectors in proportions that align with your long-term goals could be prudent. Allocating to these sectors the past couple years when the Magnificent 7 were doing well caused portfolios to underperform domestic large cap indexes. However, comparing well diversified global portfolios to domestic large cap indexes such as the S&P 500 isn't a good comparison. The S&P 500 isn't even as diversified as you may think with the top 10 holdings making up close to 40% of the index.

We continue to monitor global developments closely, but we also can't ignore the other risks that were present before this conflict. Tariffs are creating a lot of uncertainty as well and have caused the Fed to be on a prolonged pause from lowering interest rates. The longer the Fed is on hold, the more it risks causing harm to the economy. The good news is that the labor market and economy seem resilient thus far and, if trade negotiations are resolved soon, the Fed may cut rates possibly resulting in an upside surprise for investors. While things can appear gloomy, there are silver linings that are often ignored. Patience, discipline, and perspective remain the best tools for navigating an increasingly complex world. Please consult your financial professional for guidance during these times.

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