

WEBINAR SUMMARY

IRAN CONFLICT

Geopolitics, Markets & Managing Risk



Military strikes on Iran threaten to further reshape the geopolitical landscape. As the situation evolves, global investors can begin to assess how this war in the Middle East might alter the risk outlook, the economic backdrop, and asset prices across a range of sectors and regions.

A panel of PGIM experts gathered to discuss the macro and market fallout, impacts on energy and other sectors, potential spillovers for regional supply chains, and strategies for managing portfolio risks. Here are key takeaways from the webinar:

- **Macro and market scenarios:** The war unfolding in the Middle East is more expansive than recent conflicts in the region, creating new risks for global markets and making it more challenging to price in the potential fallout amid renewed instability. After the initial strikes were successful in taking out Iran's leadership, there are three main scenarios that could emerge. First, as a base case, a prolonged quagmire would likely feature muted market reaction and global shockwaves that diminish over time. This could be a net negative for riskier assets due to the possibility of spillover from a destabilized Iran. Second, the end of a repressive regime and the start of new Iranian leadership could lay the foundation for a Persian renaissance that offers significant upside for the region, the world, and the people of Iran. Third, the worst-case scenario would be if the regime holds onto power and expands the surface area of the conflict, likely bringing a longer-term supply shock for energy markets.
- **The energy impact:** The early response from oil markets was more sanguine than people may have expected given the scale of what transpired. Simply put, this is not the oil market of yesteryear. The U.S. shale revolution reduced reliance on oil exports from the Middle East. The main buyers of the region's energy production, including China, have reserves that offer a weeks-long cushion, even after the Strait of Hormuz—a key shipping lane for oil and liquefied natural gas (LNG)—was effectively shut down. The successful attacks on Iran have limited the country's capacity to keep the Strait of Hormuz closed for a longer period of time. There may be a higher risk for European countries that rely on LNG imports because U.S. export terminals are already running at capacity. While this is a potential headwind for Europe, it is unlikely to match the severity of what transpired in 2022 following the invasion of Ukraine.
- **The outlook for emerging markets:** The U.S. dollar's modest rise and the increase in Treasury yields in the immediate aftermath of the strikes suggested that a flight to quality was not in full gear. EM debt has been an outperformer of late, and market fundamentals indicate that it can prove resilient through this conflict. For instance, EM central banks, particularly in Asia, are positioned to manage volatility in exchange rates. Countries that are sensitive to oil prices are more at risk, but many of these countries are higher rated and will benefit from efforts to diversify their economies into tech and other industries. Many oil-importing countries have a supply cushion with a healthy amount of capacity for most of Asia to manage a short-term energy shock. One

key risk for EM investors to monitor is whether oil prices remain higher for longer.

- **The U.S. economic fallout:** The conflict is a reminder that investors face a tug-of-war between two significant but divergent forces in the economy: a once-in-a-generation tech boom and a fractured geopolitical backdrop. AI investments have been a boon to growth, while rising

geopolitical tensions threaten to produce more energy shocks and expand the use of economic warfare. The U.S. economy is well positioned to absorb the shocks that emerge from the war in Iran. Meanwhile, the reaction function of the Federal Reserve is unlikely to change much. Policymakers will likely view a short-term surge in oil prices and its impact on inflation as temporary.

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