



## Enter the Dragon

### A lose-lose situation for the global economy...

#### Key points:

- **Middle East conflict escalation:** oil prices surged dramatically this week amidst Iran tensions, with action in the Strait of Hormuz making headlines around the world.
- **Global supply chain vulnerability:** with 20% of global oil consumption and one-fifth of the world's LNG passing through the Strait daily, even a temporary closure creates stagflationary shock risks and potential upward pressure on food prices.
- **AI workforce displacement:** meetings this week with US banks suggested a significant displacement of jobs in their workforce, which could represent a material macroeconomic downside risk if widespread across industries.
- **A record USD66bn issuance day:** investment grade issuance totalled USD66bn on Tuesday, led by Amazon's USD37bn new issue. Continued hyperscaler spending will mean ongoing new paper coming to market, resulting in a headwind for spreads.
- **An uncertain macro outlook:** the combination of geopolitical tensions, AI disruption, and uncertain easing plans are creating a challenging environment, with elevated volatility likely across asset classes.

**London, 13 Mar 2026:** Global markets continued to remain glued to headlines coming out of the Middle East over the past week, with oil prices surging close to USD120 per barrel on Monday, before temporarily dropping back below USD90, on hopes that the conflict might be nearing its conclusion in the wake of remarks coming from President Trump.

However, it strikes us that even if the US decides that it has done enough to declare that its aims have been fulfilled, it is not clear that this would immediately see Iran agree to talks and a cessation of hostilities.

The war on Iran appears existential for the IRGC and other elements of the regime, and from this respect, surrender has never looked like an option. Consequently, it seems that Iran may only choose to desist after inflicting much greater pain on the global economy, on the hope that this re-sets a regional agenda, seeking to remove the US presence from the Gulf.

From an Iranian perspective, this may seem to be the only leverage the administration in Tehran can bring to bear, in order to ensure its eventual survival. If this is seen to be the case, it may leave the US and allies with no easy off-ramp to the current conflict, other than seeking to finish what has been started through military means.

Yet, away from the more significant geopolitical implications with respect to the trajectory of this war, more specifically, from a financial markets perspective, the only thing that really matters to the global economy is the chokepoint in the Strait of Hormuz. Simply put, if oil can continue to flow, then prospective economic disruption may prove short lived.

However, the longer that transit is blocked, so the more fields will need to be shut in, as storage capacity caps out. A global shortage of crude and associated products could see prices spiral higher and having dipped into reserves, there will only be so much that the IAE can do about this, in anything beyond the short term.

The Strait itself is a narrow chokepoint and although military escorts and security guarantees may be issued, the reality is that slow-moving bulk tankers represent a pretty soft target for cheap drones and small boats to attack. This cheap, low-tech warfare can thus maximise disruption at a minimal cost.

Thus far, although it appears that US/Israeli forces have made progress eliminating ballistic missile launchers, it is proving much more difficult to mitigate the drone threat, given their ease of deployment and cheap cost.

Consequently, it seems fair to assume that transit may well be materially impaired until such a time that Iranian capabilities have been eliminated, or until such a time that the IRGC has been persuaded to enter into some form of talks aimed at de-escalating the current conflict. Of course, such a breakthrough could happen relatively swiftly.

However, our general sense is that this situation infers that attacks will likely persist for at least another month or two and that in this period, oil price risks will continue to sit on the upside.

Furthermore, in addition to being responsible for 20 million barrels per day of crude oil, which represents 20% of global consumption, it is also worth noting that the Strait of Hormuz is also responsible for the transit of 20% of global LNG exports, 25% of global fertiliser exports, and 35% of urea exports.

In this context, its closure, even on a temporary basis represents a global stagflationary shock. For example, fertiliser deliveries which are held up today will mean that crop yields later this year are likely to suffer, putting upward pressure on food prices. Subsequently, in terms of trying to assess the inflationary impact on an aggregated basis, a lot will depend on how long trade is impaired for and the ability to re-route any of this output to other transit points.

However, our initial assessment of this would be that it seems reasonable to think that CPI prints could temporarily rise by around 1%, with around 0.5% subtracted from growth projections at the same time.

With respect to central banks, we think that it is very unlikely that the Federal Reserve, under incoming Chair Warsh, will be persuaded of the need to raise interest rates in light of these macro developments. We think rate cuts are still possible later in 2026, if the conflict clears in the next couple of months and oil prices drop, enabling policymakers to look through higher inflation in the short-term data.

Similarly, we would observe that the Bank of England has gone into this conflict with a weakening economy and an easing policy bias. Were it not for recent developments, we would have looked for the BoE to cut rates at its meeting at the end of March and although we can't see this occurring now, we think that it will take a lot for the BoE to change its stance towards a rate hiking agenda.

As for the Fed, we think this may mean that monetary easing remains on the agenda later in 2026, with the BoE models relying heavily on output gap analysis, which will infer a need to ease policy on a forward-looking basis, rather than tighten.

The backdrop for the ECB may be distinctly different. Here the institution is more likely to be sensitive to a short-term up move in inflation, having reflected that in 2022, their biggest mistake was waiting too long before they started hiking. Therefore, there is a mindset that hiking early will mitigate the total amount of policy restraint which will subsequently be required and will allow rates to fall more quickly again, thereafter.

In the US, this month's CPI release was in line with expectations, with core prices +2.5% over the year. However, economic data are very much taking a backseat for the time being, with US yields failing to react to a soft labour market report last week with jobs contracting and the unemployment rate rising.

Yet AI disruption in the labour market is a theme that needs to continue to be monitored carefully. Meetings with senior US bank executives this week suggested a projected cut in their workforce of as much as 30% on a 3-year view. Such a rapid displacement of jobs could represent a material economic downside risk at a macro level, if such outcomes occur on a widespread basis across industries.

This serves as a reminder that even if the conflict in the Middle East is all that seems to matter just in the short term, the big themes around AI, and what this will mean for economies, societies and asset prices, most certainly has not gone away for long.

Over the past week, there has been substantial volatility in short-term interest rate contracts, notably so in Europe. Although these movements have partly been justified given the change in the fundamental backdrop, it is clear that price action has been exacerbated by stop-loss closing of some large consensual positions in short-term rates and yield curve steepening trades.

In light of these moves, we have taken the opportunity to focus our UK rates exposure on the short end of the curve, where we think it is incorrect for markets to discount higher UK interest rates. In addition, we have also used a flattening of the US Treasury curve as an entry into steepening positions.

One thing that does strike us is that against a more stagflationary backdrop, so governments globally are likely to ease fiscally in order to try to mitigate voters' pain from rising energy prices. This represents an additional source of potential fiscal deterioration, which may lead to discount higher term premia. Furthermore, recent events are making increases in defence spending even more pressing, and this is also a factor which pushes in the same direction.

Movements in FX have been much more modest than in rates over the past week. The dollar has continued to push stronger across the board, but away from movements in EMFX, moves have appeared to lack much conviction. We continue to hold few strong FX views at the current point in time and although the yen has reached our targeted levels close to Y160, we don't think this is the environment in which to move long of the Japanese currency.

In Japan more broadly, we have flattened duration risk during the past week, as we think Takaichi will be more inclined to seek to ease policy, to mitigate economic downsides. However, we continue to maintain long-term conviction in Japan 10-30 curve flattening.

Credit spreads have followed moves in equities, with corporate bonds trading in a relatively orderly fashion. In investment grade, spread widening on the back of general risk reduction has been somewhat exacerbated by ongoing heavy new issuance of corporate debt. Amazon was this week's jumbo issuer, with a USD37 billion new US issue helping make this Tuesday a new record issuance day in the US IG market, with a total of USD66 billion of new issues priced. As hyperscalers show no inclination to scale back their investment spending, so it is likely that we will continue to witness an ongoing deluge of new paper coming to market over the months ahead, and this remains a headwind for spreads.

In contrast to corporate credit, price action in emerging markets seemed to show more signs of overshooting in the past week, with investors in that universe more inclined to sell first and ask questions later. On a relative basis, oil exporters have fared better than those countries importing energy, though in many respects, we feel that markets have not differentiated enough between relative winners and losers in a falling market. Elsewhere, private credit continues to generate negative headlines, with JPMorgan the latest bank to write down values in the asset class.

As previously noted, high leverage in private markets has meant that investors in this space have been desperate to see lower interest rates, but as these hopes are dashed and credit impairments increase, so further trouble may appear to sit ahead for investors in these vehicles.

On this point, it is also noteworthy the extent of exposure in these funds from investors in the Middle East region. Although we don't see redemptions in the near term, it would seem very unlikely that any new money

will be recycled into new investments from this investor base any time soon, and this could also add to a more challenging technical backdrop in private markets, if leverage gets squeezed.

### **Looking back, looking forward**

Returning to the Iran conflict, it is striking that Europe, as a whole, is a bystander to the unfolding events and is left looking very inept and irrelevant. In the UK, this has been symptomised by the delayed deployment of HMS Dragon, the one UK warship with anti-missile capabilities. With this having been stuck in port until late this week, it has prompted the joke that this ship represents the only 'small boat' that this Labour government has successfully managed to prevent from crossing the English Channel!

As for the US administration, a growing question over the coming weeks will be whether the gamble by Trump in Iran is starting to backfire. For all of Trump's attempts to calm markets and project a sense that everything is going to plan, there will be many who start to question whether there was actually much of a plan to begin with. For sure, history has taught us time and again that it is much easier to start a war than it is to end one....

### **Contact:**

Lydia Cambata

[lcambata@bluebay.com](mailto:lcambata@bluebay.com)

### **About RBC BlueBay Asset Management**

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