



## Searching for a Strait answer

### Two scenarios: negotiation or escalation

#### Key points:

- **Middle East tensions:** markets have continued to swing on contradictory messaging around US-Iran negotiations, with Iran maintaining leverage through the Strait of Hormuz closure.
- **Two divergent scenarios:** a negotiated settlement could see oil at \$80 with modest inflation, whilst escalation could push Brent above \$150 and trigger a recession in Europe.
- **Private market stress building:** the shift from expected rate cuts to potential monetary tightening is toxic for over-leveraged borrowers, though it strikes us that systemic consequences remain unlikely.
- **Macro outlook uncertain:** policymakers have revised forecasts for higher inflation and lower growth, whilst supply disruptions threaten food prices and chip production in coming months.
- **When the fog lifts:** what we do know is that the macro fog should start to lift relatively soon, once we know which direction events are moving in.

**London, 27 Mar 2026:** Events in the Middle East have continued to dominate financial markets over the course of the past week. Bonds and stocks rallied sharply on Monday, having opened the week materially lower, on Trump issuing a 48-hour deadline to Iran to open the Strait of Hormuz. Thereafter, the US President's tweet that talks with the Iranian regime were progressing well provided the catalyst for a sudden swing in sentiment.

However, with Iran continuing to deny talks and pushing back on Trump's comments, this rally has petered out over the following days. In the fog of war, investors have been left trying to guess who they should be believing, against the backdrop of conflicting messaging and signals.

Yet what seems undeniably clear is that the US administration would like to see a quick end to the conflict and the pain this is afflicting on the global economy. We have heard that at the outset of the war, the White House had been told that Iranian missile launch capabilities would be eradicated by 15 March, and so there has been a building sense of concern over recent days.

From this standpoint, it is evident that the IRGC is still in a position to launch attacks, with evidence suggesting that interceptor rocket supplies are being depleted more quickly than Iranian reserves. In the past couple of weeks, this has led to a sense of some desperation in the US, to find an off-ramp, whilst being able to declare a unilateral victory.

However, unlike April 2025, when Trump was able to course correct on tariffs in the face of building market pressure, in the context of the current conflict, it appears that such an easy reversal will be much more difficult to expedite.

In Iran, the conflict has been viewed as existential by the regime, ever since its outset, with the US and Israel making clear their intentions with respect to regime change. It also appears that the hardline IRGC and the security apparatus has been taking more of a hold on power within the country, in the wake of enforced leadership changes.

Consequently, inasmuch as the US may want to negotiate with counterparts in Tehran, there is no guarantee that anyone is actually in a position to negotiate on behalf of those who are in control of the country. Moreover, it might seem that the regime has concluded that prolonging the conflict and the closure of the Strait will play into their hands in the weeks ahead.

Although President Trump has dispatched additional troops to the region, Tehran will be aware that there is a real reluctance on the part of the US administration, to commit to putting boots on the ground and being drawn into a long and messy engagement.

Consequently, it may appear that Iran could conclude that their leverage will continue to increase over time, and it is they who will be able to determine when and how the conflict comes to an end. From this perspective, Iran has made a series of demands with respect to reparation payments, lifting of sanctions, security guarantees, and an ability to continue to control the Strait of Hormuz, cementing the country's ability to dictate events within the region.

Such terms would allow the IRGC to declare victory and potentially put the regime in an even stronger position on a forward-looking basis. However, such an outcome will be unthinkable to the US, Israel, or other countries in the Gulf, no matter how Trump seeks to twist and spin it into some form of victory of his own.

Yet, if this points to an impasse, with Iran effectively calling Trump's bluff, then much will then hang on how the US decides to react, at that point in time.

Simplistically, we could suggest two contrasting scenarios looking out into the next couple of weeks. On the one hand, Trump may continue to extend the rolling deadlines on talks, claiming progress is being made, notwithstanding a continuation of hostilities on the ground. Ultimately, most wars end in some form of negotiated outcome. In the context of ongoing discussions, it is possible that the US gives Iran enough of what it wants, in order to declare an end to hostilities in the next few weeks.

In this scenario, we see oil prices trading back down to around \$80, though ongoing disruption to trade will still see global inflation rise around 0.8%, with a 0.4% hit to growth as a result. In such a scenario, risk assets can rally but are unlikely to reach previous highs in stocks or tighten in credit spreads. We would also assume that against this backdrop the ECB may hike rates by 0.25% as an insurance policy, though the BoE and Fed are likely to maintain monetary policy unchanged.

In the second scenario, this sees the US concluding that talks are going nowhere and the only option will be to 'finish the job' that it started at the beginning of the month. From this perspective, it has been interesting to witness a hardening of the position of Saudi Arabia and other countries in the Gulf, who are horrified at the thought of an Iranian regime being left in a position where the IRGC operates as a regional mafia, controlling access and terms to navigate the Strait of Hormuz, holding these states to ransom in the process.

In this scenario, a US-led ground campaign triggers further escalation in the conflict and Iran is likely to wreak as much damage as it can through sustained attacks, in the hope that this brings the global economy, financial markets and the US to its knees. Such escalation would be highly problematic and in such a case, we might assume that this effectively takes 10 million barrels (around 10% of global output) off the market for the next 12 months, before supply elsewhere can be increased to meet the shortfall.

In an escalation, we think that the US will move quickly to restrict energy exports, pushing down domestic prices in order to protect US consumers and businesses from the worst of the conflict. However, the impact

on European and Asian economies is likely to be severe, with oil prices needing to rise to a point where demand destruction is able to restore a balance between supply and demand, likely north of USD150 per barrel on Brent crude.

Consequently, we might think that the US economy may continue to see GDP growth around 2% with inflation peaking at 4%. In contrast, we would expect Europe and the UK to move into recession in this scenario, with CPI rising to 4% in the Eurozone and 6% in the UK.

Were this to be the case, it strikes us that the Fed could be pushed to hike but would probably try to maintain policy on hold. Meanwhile, the ECB and BoE may be forced to hike by 100bps in the months ahead, in order to ensure that an energy price shock does not lead to a de-anchoring of price expectations in the medium term.

In this adverse scenario, we also believe that we will see widespread fiscal deterioration, as a result of weaker tax receipts, moves to protect vulnerable consumers from higher energy costs, and the urgent imperative to add to defence spending at a time of elevated global instability. Consequently, in this case government bond yields may continue to rise along the yield curve, and it is likely there will be a more material re-pricing in risk assets.

To this point, we have already seen some very substantial re-pricing in global rates markets yet moves in equities and credit have been relatively modest in comparison. In part, this price action is explained by what we lived through in 2025. Last April's policy reversal was a catalyst for prices to start rallying and not look back.

Consequently, investors have been programmed to look for a similar trajectory in the current crisis and with Trump clearly looking to draw war to a quick end, so investors have been encouraged to think that this moment is not far from being at hand. This being the case, investors in these asset classes have wanted to 'look through' the current conflict and have been disinclined to adjust portfolio positioning.

However, if the reality of the adverse scenario becomes manifest, then this could suggest there is plenty of scope for this complacency to be challenged to adjust to the new reality that comes into view.

Reflecting on this investment landscape, we would infer that it is very difficult to take active risk at this moment in time. Market volatility in rates has been painful during the past month, and we have moved to close positions in the wake of negative price action. Our active positioning for now has been largely flattened out.

However, what we do know is that the macro fog should start to lift relatively soon, once we know which direction events are moving in. At this point, we are positioned to be able to adopt a more decisive stance.

We have seen in the past that market dislocations create opportunities to generate material performance, when positioned to be able to add risk at the right time (often when others are selling theirs). Consequently, a cautious stance appears the appropriate one just for the time being.

Elsewhere, away from the Middle East, we have continued to see stress continuing to build, with respect to private markets. Given elevated levels of leverage in this space, we have noted how elevated interest rates since 2022 have meant that free cashflow is being eaten up by debt servicing costs, starving companies' ability to deliver profits and thus impairing the ability to IPO.

With private assets getting stuck, then there is not much that needs to go wrong before credit impairment comes onto the agenda. With defaults >5% and a further 20% of the universe in PIK format, instead of paying coupons, so stress has been building for some time.

This has been given added impetus by concerns for prospective AI disruption to businesses in the software sector, which accounts for close to 30% of the issuance universe in these funds. Consequently, private markets are desperate to see lower interest rates, in order to get some relief.

However, now that prospective rate cuts in the months ahead have been replaced by the possibility of possible monetary tightening, this is seen as toxic for borrowers who are over-leveraged. This is adding to the pain being felt in private markets, at a time when portfolio write-downs also see investor sentiment sour on the asset class.

This said, a larger fallout in private markets is unlikely to have systemic consequences in our view, given that exposure is diversified across an investor base who will remain locked into structures over an extended period. There may be issuance pressure in public markets as some issuers return to issue loans and bonds as demand in private assets dries up, and this may be a factor weighing on spreads.

It is also likely that a material correction would weigh on US bank balance sheets, given exposures that have accumulated. Yet, European banks look to be in a much stronger position, relatively speaking.

In this context, even were we to see an adverse economic scenario in the Eurozone which pushes non-performing loans higher, the fact this may coincide with elevated interest rates will support net interest margins and help support bank profitability. Consequently, were we to witness a material sell-off in bank debt in the wake of increased volatility and downside risk, this is an area we would look to add back, looking at value on a medium-term perspective.

Meanwhile, in emerging markets, we note that the mindset of investors in this space in any crisis tends to be to sell first and ask questions later. As a result, in the initial phase of any sell-off, the most widely owned assets are those that fall the most.

In this respect, it is notable to assess the relative underperformance of local bonds in countries such as Colombia, Brazil and Mexico – all of whom are oil exporters in a region far from being exposed to the conflict in the Middle East. In the next phase, after initial de-risking is completed, we think there will be more of a focus on relative value opportunities in EM.

### **Looking ahead**

Higher oil and gas prices are already having an economic impact on a global basis, with policymakers revising inflation forecasts higher and growth lower as they reflect on the economic outlook as a result of the ongoing disruption. It is also noteworthy to reflect on Ukrainian attacks on Russian ports, impacting up to 40% of potential oil export supply, as Ukraine seeks to ensure that Russia does not become a winner at a time when higher crude prices have the potential to boost their coffers.

Meanwhile, with force majeure clauses being triggered on various contracts, there is scope for nationalistic policies to limit exports in order to protect domestic interests, meaning that the economic pain going forward may not be equally felt on a country-by-country basis. Additionally, weaker harvests as fertilizers supplies are missed also suggest a risk to food price inflation in the months ahead.

Meanwhile, a shortage of helium has the potential to disrupt high-end chip production, leading to shortages, which will also be reflected in lower growth and higher prices.

Against a torrent of contradictory information, trying to separate the truth from lies and misdirection is not as straightforward as one might think that it should be at the current point in time. For example, it is very possible that Trump's claims of progress in talks are actually a smokescreen to buy time, at a moment when he is amassing troops ready for an assault. It is also possible that Iran is more committed to reaching a deal and ending the conflict than they currently claim.

Against this backdrop, it is understandable that markets feel like they are trading on something of a knife's edge. Of course, history will be the judge of this, but it does say a lot that even US commentators are sceptical of comments from their own commander-in-chief, in the midst of a war.

Strait answers seem difficult to discern, but all should be revealed over the next few days. It makes sense to hunker down until then, though as a closing observation, one thing that does strike us is that rates markets

have been much quicker to discount an inflation shock than risk assets have been in discounting the growth shock, at this stage. This could well reverse in a more adverse scenario, looking forward from here.

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