



## The past month summed up

The Iran war forces markets to shift focus from the new economy – artificial intelligence (AI) – to the old, in the form of oil.

## The rationale

Our central thesis has been that the AI-led boom had begun to broaden to a wider industrial manufacturing recovery both in the US, but also across the wider global economy, supporting opportunities for growth beyond America. Alongside continued material government support for infrastructure and business and the fading influence of tariff uncertainty, stable inflation meant that central banks were more likely to cut rates than to hike them, providing a supportive environment for investing.

However, our assertion was that the most likely challenges to this positive scenario were either inflation remaining stubbornly high or where President Donald Trump's unpredictability threw a spanner in the works. It now looks like the latter factor most certainly has challenged the status quo, which has subsequently increased the threat of the former.

The decision by the US along with Israel to attack Iran has of course created a hornet's nest of geopolitical issues that could reverberate around the world for a long time. Our focus however is on the investment ramifications; quite clearly there is only one central narrative in terms of the global economy and markets that has emanated from this war, and that is the story of oil.

## There are still some things that matter more than AI

No matter how much it might have looked like technology and artificial intelligence were taking over our lives, it still turns out that not much can happen without the energy source that has spurred global industry over the past century. Given the importance of the Gulf states to global energy production, with around a quarter of the world's oil and gas coming through the Strait of Hormuz, Iran's response to the attack has threatened huge disruption of the global supply of oil and placed substantial pressure on prices of Brent crude oil. Costs have shot up from \$72 a barrel the day before hostilities to \$104 as of writing this article, a climb of 44 percent.

Oil has been the principal catalyst for the nature and scale of reaction from markets, which, rather than speculative or hysterical as can often happen in times of stress, has been largely rational and controlled thus far. The S&P 500, which has dipped a relatively modest 3.5 percent since the first day of the war, has been remarkably sanguine about one of the most significant conflicts in recent years – a war where the strategic goals are not exactly clear and where it seems the US may have underestimated both the staying power of the ruling regime and its ability to cause sustained economic and military havoc. But in fact markets have proven reasonably precise in assessing risks and impacts; the reason why the US has not been hit so much as others is because of the country's substantial domestic energy resources. This insulates them from disruption of supply, with added resilience from their status as a net-exporter.

## Discerning between the haves and have nots

Instead, those nations and markets that look most vulnerable are those without their own resources making them reliant on imports. Witness Europe, which you might remember suffered in the early stages of the Ukrainian war from its reliance on Russian natural gas. It is now seeing its stock markets decline more precipitously – the Europewide Stoxx 600 index has declined 6 percent since the start of hostilities. Likewise, big importers such as South Korea and Japan have suffered with their stock markets falling 6.4% and 8.5% respectively. One place where worries of an oil shock are more muted is in China given it has a strategic oil

reserve of about 1.5 billion barrels meaning it can hold out for the moment; the MSCI China index, a measure often used by international investors, is barely changed.

And that is the nub of the issue as far as a more generalised shock to the system is concerned. While the US is less susceptible to the economic consequences of rising oil prices, it doesn't mean it's immune. The longer this goes on, and prices for gas have risen considerably in the US in recent days, the more this will have an effect on the US economy. We've noted before the importance of the US consumer in maintaining growth – the more money it has to spend on gas the less money to spend on other items, whilst high energy prices tend to hurt confidence. Similarly, the more money that companies have to spend on energy means less money spent on R&D and other more economically productive activities such as investment. In other words, the biggest risk is a stagflation shock – one that both caps growth and sends inflation higher.

## Elimination, elections and economics

Higher prices in the US would set back the timetable for interest rates cuts by the Federal Reserve. Expectations that interest rates would fall a further 0.5% in the US are being challenged, whilst in the UK and Europe expectations have already changed and rates are now forecast to rise rather than fall. Higher interest rates tend to be a headwind for borrowers and growth.

The question of how big an impact will be a case of how high prices rise and how long the disruption continues. Despite statements that the conflict will continue until the Iranian regime is eliminated, there is a prevailing view that political calculations will ultimately outweigh strategic military drivers – especially given how unclear those seem. With the Trump administration under pressure on the issue of affordability ahead of the midterm elections, higher prices at the gas pump as well as rising costs of fertilisers and potentially food are viewed as likely to lead to the President declaring victory sooner rather than later.

Prices for the delivery of oil in months to come have consistently undershot those for immediate delivery indicating that traders expect this to pass (although those prices have risen each day that the bombing has continued). Future inflation expectations also point to a quick resolution as they have not materially risen. This further explains the measured response of markets thus far.

Then there is the other perspective which acknowledges that the war has created a new situation which can't be unilaterally reversed by the US. As the Economist points out Iran has now experimented with and seen the success of its economic warfare model and the regime, whilst severely damaged, has not been displaced. Equally Israel has shown few signs of wanting to de-escalate a war that has deeply existential drivers. New reports suggest that analysts at investment banks are becoming increasingly agitated about the war and its potentially enduring consequences.

So as of now, our central thesis still holds. The spending on datacentres shows little sign of abating with commitments soaring over \$600 billion and Nvidia expecting sales of \$1 trillion in the next two years. The broader industrial drivers of infrastructure renewal, electrification and domestic security look well supported – in fact recent events should strengthen these national economic priorities. However, the longer this war goes on, the greater the risks of economic accident and the more we'll need to reassess our balance. The consumer, already squeezed in terms of affordability and the cost of living, looks especially exposed.

## Green is back

If one of the lessons from this war is that amid all the hype surrounding artificial intelligence oil still matters, another one is that amid all the concerns about spiralling US debt and its gargantuan borrowing burden, the US is still an economic refuge in times of stress. In fact, the US happily sits at the centre of its own virtuous circle – the moniker of the dollar being the world's reserve currency is what allows it to keep on borrowing happily even while other countries would have seen their ratings evaporate under similar circumstances. This works while it works...and it's still clearly working: The dollar index, a measure of the US currency's worth against a basket of others, has climbed 3 percent since the start of the war; the euro has slid 2.5 percent; the

British pound has slipped 2.2 percent; and even the Japanese yen and Swiss franc, normally also considered safe havens have declined against the dollar.

For global investors such as us, the dollar has proven a helpful shock absorber.

## Conclusion

In a news cycle dominated by the current conflict it may be hard to perceive that businesses continue to operate and that life goes on. Still, the choking off of the global oil supply is a major concern for both businesses and consumers.

The key element in this environment is time – the longer the crisis continues the less able, even those with their own oil sources or reserves (i.e. the US and China), can remain relatively immune and the more damage that will be done to the economy. Historical precedent would point to a benign outcome. Over the past four decades there have been 21 US air strike campaigns in the Middle East, and on 95% of occasions the S&P 500 has been higher eight weeks later. Whilst avoiding complacency, now is a time for perspective rather than panic.

With a portfolio primed for growth but constructed to be resilient to shocks such as this we are not taking any precipitate action today. Focus remains on our process of examining our equity portfolio to find the most valuable opportunities across the globe whilst assessing any specific vulnerabilities to any deterioration in the current situation. Our fixed income investments remain tilted towards the prospect of inflation staying higher for longer, while gold and hedge fund assets help protect and diversify our portfolio amid the current ructions.

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