

The Raging Storm: Middle East Escalation and the Global Fixed Income Reckoning

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The Raging Storm: Middle East Escalation and the Global Fixed Income Reckoning

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The effective closure of the Strait of Hormuz following US–Israel strikes on Iran and Iranian retaliation has triggered the most severe oil supply disruption in modern history, with no end in sight and crude trading at or above \$100/bbl. The shock is cascading through global fixed income markets via three simultaneous channels: reignited inflation expectations forcing a repricing of the global easing cycle; widening credit spreads as recession probability rises for energy-importing regions; and a powerful USD safe-haven bid tightening dollar funding conditions worldwide. A swift de-escalation would most likely lead to a risk reversal across asset classes, but even then, the disruption caused by the Hormuz shutdown will keep an upward bias to energy prices. This note assesses the transmission mechanisms across DM rates, global IG and HY credit, EM hard-currency sovereigns, and GCC regional names, and sets out actionable positioning views across each segment.

The overarching **portfolio construction principle in this environment is differentiation**: between energy exporters and importers, between robust and leveraged balance sheets, and between liquid and illiquid structures. The rise in risk premia and USD funding stress makes these distinctions more consequential than at any point in recent memory.

Portfolio action based on possible scenarios:

Scenario	Market Implications	Positioning Response
Sudden Ceasefire / De-escalation	Sharp reversal in USD; front-end yields rally; risk assets snap back. Oil collapses below \$80/bbl.	Add duration; rotate into HY and EM beta; close steepener; take profit on oil hedges.
Prolonged Disruption (Base Case)	Oil stays \$90–110/bbl.; yields grind higher; credit spreads remain elevated; EM differentiation widens.	Maintain underweight duration; prefer quality over beta; keep tail hedges; build GCC pipeline.
Further Escalation / Wider Conflict	Oil spikes above \$120/bbl.; global recession fears; flight to quality accelerates; EM and HY face acute stress.	Maximum defensive: short duration govies; cut all HY/EM beta; scale up CDS and vol hedges.

Key Market Snapshot

Indicator	Current Level / Move
Brent Crude	~\$100/bbl. (biggest supply disruption in history)
US 10Y Treasury Yield	Above 4.26% (from below 4.0%)
US 2Y Treasury Yield	Backing up; front-end cuts repriced
European Core 10Y (Bunds/OATs/Gilts)	Multi-month highs
USD Index	Strong safe-haven bid
IG Credit Spreads	Moderately wider; secondary liquidity thinner
HY Credit Spreads	De-rated faster than IG
EM Sovereign Spreads	Wider; outflows accelerating
GCC IG Spreads	Flat to slightly tighter post-gap

The Strait of Hormuz has been effectively closed following a cycle of US–Israel military strikes on Iran and subsequent Iranian retaliation, with drones and missiles hitting multiple tankers and mines reported near key shipping lanes. Crude oil has traded at or above \$100 per barrel as the market prices what constitutes the largest oil supply disruption in recorded history, with shipping firms diverting or pausing all traffic through both Hormuz and the Red Sea. The magnitude of this disruption is without modern precedent. Approximately 20–21% of daily global petroleum consumption transits the Strait of Hormuz under normal conditions, and the simultaneous disruption of Red Sea shipping compounds the logistical shock to global energy supply chains.

Rising oil prices have reignited inflation concerns across all major economies, forcing a fundamental reassessment of the global monetary easing path. Markets have pushed back expectations for the Fed's first rate cut, with similar repricing across European and Japanese curves. US 10-year Treasury yields have moved from below 4.0% to above 4.26%, while 2-year yields have also backed up. Core European 10-year benchmarks — Bunds, OATs, and Gilts — are trading at multi-month highs. The dynamics represent a classic “late-cycle bear steepening lite” pattern: front-end rate cuts are being repriced later in the cycle, while the long end cheapens on rising inflation risk and a rebuilding of term premium. Against this backdrop, we favour a mild underweight in long nominal duration (10–30Y USTs and Bunds), maintaining core exposure in the 3–7Y part of the curve where the policy anchor remains strongest. On the curve, a modest steepener in USTs (2s10s or 5s30s) captures the upside risk to term premium against a still-anchored front end.

Global bond markets have experienced one of their worst weeks in months as the conflict simultaneously boosts inflation expectations and recession probability in energy-importing regions, pressuring risk assets broadly. Money managers are shifting toward haven-first allocations — US Treasuries, Swiss francs, and gold — while reducing exposure to equities and high-beta credit. Even traditional havens like gold have seen intermittent profit-taking as investors raise USD cash balances. In spread terms, the transmission is straightforward: EM sovereign and HY corporate spreads have widened materially, particularly for oil importers and fragile credits. Energy-exporter credits are fundamentally supported by higher oil revenues but remain vulnerable to global risk-off sentiment and liquidity withdrawal.

Primary markets in Europe and selectively across global IG have paused or slowed considerably, with new-issue concessions rising and several deals pulled. Cash IG spreads are only moderately wider, supported by solid balance sheets and still-healthy earnings buffers, though secondary liquidity has thinned noticeably. ***Within the IG space, we prefer high-quality corporates and financials with strong pricing power in energy-linked or non-cyclical sectors, while avoiding tight, long-dated BBBs that depend on benign funding conditions.*** The better entry point lies in waiting to recycle into wider new issues once primary reopens with fatter concessions, funded by selling the tightest secondary paper.

HY has de-rated faster than IG on the back of higher recession probability for energy-importing regions and tighter financial conditions. Private credit faces a particularly challenging combination of higher long-end yields, fading growth, and tighter liquidity, with mounting concern over lower-quality sponsors and covenant-lite structures. ***Within HY, we favour a barbell approach — retaining only top-tier BB-rated names with near-term refinancing visibility while scaling back CCC exposure and long-dated, highly leveraged structures. For flexible mandates, buying liquid HY indices such as CDX HY during stress episodes offers a practical hedge for underlying private credit and illiquid loan book exposures.***

The US dollar is holding a strong safe haven bid as global investors seek liquidity and depth, amplifying the tightening impulse through stronger dollar funding conditions. ***This combination of higher core yields and a stronger USD is acutely negative for EM local-currency curves and FX***, raising refinancing risk for weaker corporate and sovereign borrowers reliant on external capital markets. The feedback loop is self-reinforcing: rising oil prices drive inflation expectations higher, which delays rate cuts, which supports the dollar, which tightens global financial conditions further — particularly for the most vulnerable borrowers.

EM hard-currency debt has seen outflows and wider spreads through the standard three transmission channels: higher oil prices, a stronger US dollar, and weaker global risk sentiment. Energy importers with fragile external positions — particularly certain North African sovereigns — screen as most vulnerable. By contrast, stronger reserve-backed stories are holding up better and could mean revert tighter once the immediate geopolitical stress subsides. ***We remain underweight vulnerable oil importers characterised by weak FX reserves, wide current account deficits, and near-term Eurobond maturities, while selectively adding to higher-quality EM exporters and quasi-sovereigns where elevated oil or commodity prices strengthen fiscal buffers and where index weight and ownership technicals provide support. On FX, we keep EM currency risk tight, preferring hard-currency exposure over local in this USD-strong, oil-up environment.***

GCC spreads initially gapped wider on headline risk and de-risking by global investors but have since meaningfully retraced, with IG now flat to slightly tighter relative to pre-conflict levels. Banks have outperformed corporates — including in subordinated debt — while HY real estate has materially underperformed. The primary market remains effectively shut through Ramadan and the duration of the conflict. ***We are overweight GCC sovereigns and high-quality quasi-sovereigns and see value in accumulating selected bank senior paper and well-structured AT1s and RT1s on any renewed geopolitical widening, given the still-strong capital and profitability profile of the region's banking sector. HY real estate and structurally weaker corporates remain underweight until spreads fully reprice the construction, funding, and demand risks embedded in a sustained higher-rate and higher-uncertainty environment. Tactically, we are holding dry powder for a reopening of the primary market; new supply from strong GCC credits is likely to come with a "security premium" that mean-reverts quickly once geopolitical tensions ease.***

The current environment warrants **elevated allocation to tail-risk hedges. Oil call options, rates and equity volatility, and CDS indices all offer asymmetric payoff profiles against further escalation. However, portfolios must also remain mindful that a sudden ceasefire could trigger a sharp reversal in the USD and front-end yields, punishing excessively defensive positioning.**

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