



Positions in oil can also serve as a portfolio hedge against a worsening crisis in the Middle East, and CIO believes market fundamentals are positive. (UBS)

Further volatility expected amid elevated tensions in the Middle East

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Israeli troops entered Lebanon on Tuesday, in a land offensive against Hezbollah after days of air attacks. The Israel Defense Force said the ground raids into their northern neighbor were “limited, localized, and targeted.” This is Israel’s first land operation against Hezbollah since 2006.

On Friday, an Israeli attack killed Hezbollah’s leader Hassan Nasrallah, along with other top leaders of the group. Hezbollah’s deputy, Naim Qassem, said on Monday that the group’s forces were “ready if the Israelis decide to enter by land.” Hezbollah has targeted Israeli positions for months and sent rockets deeper into Israeli territory since last week.

The recent conflict escalation adds to the risk that a multi-front war develops between Israel, Hezbollah, and Iran and more of its proxies.

However, there were few immediate signs of a risk-off move in markets following the news. The price of Brent crude, which has the potential to spike if a broader regional conflict disrupts oil supplies, was little changed at the start of trading in Europe. Gold, which often benefits from safe-haven flows during periods of geopolitical uncertainty, rose by 0.4% to USD 2,644 an ounce—though it is below an all-time intra-day high of USD 2,685/oz struck last week. The US dollar and 10-year US Treasuries, other assets with safe-haven characteristics, were also little moved and S&P 500 futures were flat.

Investment implications

The conflict in the Middle East raises urgent humanitarian concerns. It has also contributed to periods of market volatility, amid concerns that a regional war could interrupt oil supplies. So far, however, the most recent deterioration has had a limited impact on global markets, with the price of Brent crude little changed at the start of the week and the S&P 500 almost flat on the day.

In our base case, we expect global markets to be occasionally affected by the conflict in the Middle East, but do not assume an all-out war between Israel and Iran, including their respective allies. We also assume that energy flows from the Middle East will continue without sustained interruptions. Meanwhile, we think the outlook for equities will be supported by a soft economic landing in the US, combined with Federal Reserve rate cuts, strong earnings, and optimism over the commercialization of artificial intelligence.

At the same, we do think investors should consider strategies to reduce the impact of market swings on their portfolios. Gold continues to have appeal as a hedge against geopolitical risks and potential shifts in US policy arising from the election. The metal should also benefit from further Fed rate cuts, robust central bank demand, and rising investor appetite via exchange-traded funds. We expect gold to reach USD 2,750 an ounce by the end of the year and to USD 2,900 by the final quarter of 2025, up from USD 2,644 at the time of writing.

Positions in oil can also serve as a portfolio hedge against a worsening crisis in the Middle East, and we believe market fundamentals are positive. Stimulus from China and a strong start to the easing cycle from the Fed should support demand for energy. Meanwhile, production increases from the US and Brazil have been slowing, and output from Libya is depressed. Our base case is that Brent will trade around USD 87 a barrel by the end of the year, from USD 71.74/bbl at the time of writing.

In the downside risk case of a multi-front war, oil prices would be a key transmission mechanism from the conflict into global markets. While Iran has an interest in keeping energy flows unobstructed in the region, given its own dependence on oil exports, any impediment to Iranian flows may change the calculus and lead to disruptions. A disruption to major oil supply routes like the Strait of Hormuz or damage to critical oil infrastructure could see Brent crude prices break above USD 100/bbl for several weeks.

While we expect further volatility in the coming months amid elevated tensions in the Middle East and the run-up to the US election in November, we do not believe investors should make major adjustments to their portfolio in response. Historically, the effects of international conflicts on markets typically fade fast. Since 1941, we estimate that the S&P 500 has been higher two-thirds of the time in the 12 months after the start of a geopolitical crisis, and half the time, markets have taken just a month to recover.

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