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Volatility returns after an unusually smooth rally in equities

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Equities fell and safe-haven assets gained ground on Friday following reports of a strike on an Iranian military airbase. While news is still emerging, the explosions at the base near the city of Isfahan were widely thought to be an Israeli response to last weekend's unprecedented direct drone and missile attack by Iran.

The strike on Iran comes at a time when risk assets were already under pressure, amid concerns that US interest rates will stay higher for longer. Earlier in the week, Federal Reserve Chair Jerome Powell indicated higher-than-expected inflation readings over recent months would likely delay the start of monetary policy easing. Investors will now be hoping a strong first-quarter US earnings season, which is now in full swing, can help restore confidence.

What comes next?

The next steps from both Iran and Israel will be crucial. Iran warned in recent days that it would react immediately and strongly to Israeli aggression and said on Thursday that it may rethink its ambitions regarding its nuclear program if its nuclear sites were attacked. Israel sees Iran working toward a nuclear bomb as an existential threat. However, Iranian state media have reportedly downplayed today's strike so far, and the International Atomic Energy Agency (IAEA) confirmed that there was no damage to Iran's nuclear sites. Assuming the strike was carried out by Israel, and no further near-term retaliation is launched, its limited nature can be seen as a measured response to last weekend's attack.

In our Global Risk Radar published on 15 April, we argued that neither Iran, Israel, nor the US have a genuine interest in letting the conflict in the Middle East escalate further, but that miscalculations can happen. Given the currently available information, we still think that both Iran and Israel are trying to walk a fine line of not letting aggression go unpunished, but also not to take actions that force the other side to react in an escalatory manner. This would speak for our base case of attacks and tensions in the Middle East persisting in the coming months, but without a major direct confrontation.

Still, the likelihood of this happening has increased significantly over the past week. Apart from miscalculations, continued fighting between Israel and its allies, and Iranian proxies means that calculations and risk assessments by the parties involved can easily shift as well.

How do we invest?

Volatility has returned to markets after an unusually smooth rally in equities since late October. In our view, markets could remain choppy in the near term as geopolitical risks remain elevated, and markets adjust to a likely delay in the start of US rate cuts. But we would caution against exiting markets in response to flare-ups in international conflicts. Barring a serious disruption to oil supplies or trade routes, which remains a risk, the effects of such episodes has tended to be short-lived. Since the attack on Pearl Harbor in 1941, the S&P 500 has been higher two-thirds of the time 12 months after the start of a crisis. Half the time, markets have only taken a month to recover, according to our analysis.

Instead, we favor alternative strategies to improve the resilience of portfolios that enable investors to participate in market rebounds. We continue to highlight long positions in Brent crude oil as the preferred option for hedging against a further escalation. Allocations to gold and US Treasuries could also help protect against adverse outcomes. We think these assets are also well supported by fundamentals and so should also deliver positive returns in our base case. Investors seeking to smooth returns can also consider structured strategies, which could enable them to retain exposure to further potential gains in stocks while reducing sensitivity to a correction.

We also like macro hedge funds, which should be well positioned to capitalize on a turn in the interest rate cycle and help investors navigate geopolitical shifts. Finally, systematic allocation strategies can provide an additional risk management element, by significantly adjusting a portfolio equity allocation in response to changing economic and market trends.

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