CIO believes 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. (UBS)

Middle East escalation fears prompt risk-off move

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Iran on Tuesday launched a missile attack on Israel, adding to concerns that the conflict could escalate into a full-scale war between the two nations. The Israel Defense Force said that nearly 200 missiles had been fired, with most intercepted. One casualty has been reported in the West Bank so far.

The attack came hours after Israeli troops entered Lebanon earlier on Tuesday, in a land offensive against Hezbollah after days of air attacks. The Israel Defense Force described the ground raids into its northern neighbor as "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.

Anticipation of Iran's retaliation, which had been widely flagged in media reports, caused a risk-off move in markets, which had been largely unmoved by news of Israel's ground offensive. Gold, popular for its safe-haven characteristics during periods of geopolitical uncertainty, rose nearly 1% and is now trading around USD 2,651 per ounce. The price of Brent crude, which has the potential to spike if a broader regional conflict disrupts oil supplies, rose 2.5% on Tuesday and gained further ground on Wednesday.

What could come next?

The extent of the risk-off move in markets will depend on whether the Middle East conflict worsens further. The military situation in the region remains fluid and the potential for further deterioration has increased. Israel's and Iran's future actions will be crucial and risk triggering a wider war. Similarly, other members of the "Axis of Resistance," a group of Iranian allies that are also hostile to Israel, may contribute to the escalation with their actions.

But our base case is still not for an all-out war between Israel and Iran. There are some signs that Iran's attack may have been intended to signal its resolve, without provoking a more forceful retaliation from Israel. A missile assault on Israel by Iran in April was telegraphed in advance, caused little damage, and led to a limited attack from Israel on an Iranian military base. Following Iran's attack in April, the US urged Israel to respond with restraint.

Iran early Wednesday suggested its attack on Israel was over for now, barring further provocations. Israel vowed a "painful" response to Iran and US National Security Advisor Jake Sullivan said: "There will be severe consequences for this attack and we will work with Israel to make that the case." We await further information on whether the countries involved follow prior patterns.

There have been other signs that Iran may wish to deescalate, in exchange for some relief from economic sanctions. Iranian President Masoud Pezeshkian signaled to the UN General Assembly that Iran is "ready to engage with participants of the 2015 nuclear deal." Iran faces its own domestic challenges, as evidenced by large-scale protests in 2022 after the death of Mahsa Amini, who died in police custody after being arrested for not covering her hair. Iran may not be interested in entering all-out war with Israel when Axis of Resistance members are weakened, and the US has boosted its presence in the region.

That said, hardline views may yet prevail. The risk of a miscalculation by Iran, its allies, or Israel continues to increase.

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. But our base case is that the conflict stops short of 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 believe 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 USD 2,900 by the final quarter of 2025, up from USD 2,651 at the time of writing.

Equally, positions in oil can serve as a portfolio hedge against a worsening crisis in the Middle East, while market fundamentals are also positive, in our view. Stimulus from China and a strong start to the easing cycle from the Fed should support energy demand. 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 per barrel by year-end, up from the current USD 75.12.

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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