QUARTERLY INVESTMENT REVIEW

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"The guerrilla wins if he does not lose. The conventional army loses if it does not win." Kissinger

Stock markets' strong performance in 2025 continued into the first two months of this year, despite an increasingly disturbing geopolitical backdrop. On January 3rd US special forces captured President Maduro of Venezuela and brought him to face trial in New York on charges of narco-terrorism. As the quarter progressed President Trump sought to annex Greenland, an autonomous territory of Denmark, and rhetorically suggested that the US could annex Canada, and announced his intention to 'take Cuba'. However, all these events were overshadowed by the US/Israeli attack on Iran on the last day of February, to which Iran responded by effectively closing the Straits of Hormuz through which 20% of the world's energy is exported, along with many other derivative products. This conflict has resulted in the largest global energy disruption since the Second World War. The oil price rose 68% during March. It has also exposed serious cracks in the NATO alliance, and the role of the US as a benign global hegemon which has prevailed since 1945. As a result, stock markets gave up the gains made early in the year. At the end of the quarter the performance of the MSCI World Index was down 3.4%, the US 10-year Treasury was down 0.1%.

At the end of the quarter the situation remains fluid, uncertain and binary. The overwhelming military capability of the US, which destroyed the Iranian conventional military forces, has proven impotent in its ability to keep Hormuz open due to the threat of attacks on the slow-moving oil tankers which are vulnerable to aerial drones and remote-control speed boats packed with explosives. The US warships themselves have also had to back away to avoid drone swarms and naval mines. The Iranians have thus managed to exert a chokehold on this vital sea passage. While a few ships have been able to pass through with Iran's permission, the stalemate presents a significant threat to the world economy, and one that will increase exponentially the longer it continues. The rising danger is through inflation as shortages of materials lead to their prices being bid higher. On top of the delays in shipping, there has been damage to the region's energy infrastructure that some reports have said will take up to five years to repair, which may lead to longer lasting effects.

The disruption to the oil market has tended to dominate the headlines but its effect is felt more through refined products like diesel, jet fuel and naptha. There are 68 oil refineries in the war zone, located there because of the region's cheap energy, and used to produce a myriad of products that underpin the world economy. The use of fossil fuels is deeply interwoven into the modern economy which is dependent on its smooth supply. Oil and gas play a leading role in energy storage grids, fertilisers to grow food, and naptha for plastics, besides its better-known use in transportation. For example, Taiwan relies on LNG (liquefied natural gas) for 40% of its grid power, and a third of that LNG comes from Qatar. LNG is hard to stockpile and if the country is forced to ration power to the industrial sector this disruption will have knock on effects for the US technology sector that depends on Taiwanese production of semiconductor chips for its AI revolution. The Gulf also supplies a third of the world's helium, another critical input for semiconductor manufacturing and aerospace applications. The Middle East supplies a significant amount of sulphuric acid which is necessary in the production of copper, nickel and uranium, all of which play important roles in the energy transition. A third of the world's fertilisers pass through the Straits and this crisis is occurring at the worst time for farmers as it is coinciding with the Spring planting season in the Northern Hemisphere, which is likely to feed through into food inflation in several months' time.

More generally high energy prices impact the general economy in several ways. First the higher prices leave the consumer with less money to spend on other goods and services. Second, the uncertainty causes consumers to delay purchases of big-ticket items. Third, concern about job losses causes consumers to save more and spend less. Fourth to the extent that it raises prices and Central Banks are forced to raise interest rates which also curb spending. The problem is that it is difficult to displace oil quickly. Cars can't be switched overnight to other energy sources. Factories and houses that are set up to run on oil or gas can't be changed quickly to an alternative energy supply.

So, the impact of the current crisis bodes poorly for the world economy. Previous oil crises on this scale have usually resulted in recession. The 1970's experienced the worst case. In 1973/74 the world had to cope with 4 – 5 times rise in the oil price, though the global economy was more fossil fuel intensive then. Nonetheless stock markets look vulnerable as this crisis arrives at a point when the hyperscalers are spending $600 billion on capex this year, and when the opaque world of private credit is showing signs of stress, and $3.8 trillion of private equity inventory waiting for an exit. The more rising energy prices pressure that financial architecture the greater the chance of a disorderly unwind. Equally challenging for markets is that the Gulf states have been providing the liquidity underpinning American markets by recycling their energy profits into US Government debt and the US stock market. There must be a risk that these flows will be interrupted, not only because of the interruption of their oil and gas production, but also their need to redirect their wealth to support their populations and rebuilding their damaged infrastructure. The potential loss of these flows comes at a precarious time for many western countries. The debt of the US Government, for example, has reached $36 trillion and is increasing at a rate of $2 trillion a year. The UK Government's welfare budget now exceeds its income tax receipts. If the current situation worsens western governments will have far less leeway to support their economies than they did in the Global Financial Crisis of 2008, or the Covid crisis in 2020. An already difficult situation could become acute.

While the Hormuz Straits are blocked the markets will remain under pressure, but if a solution can be achieved and the ships and oil flow again, the outlook that prevailed before war broke out can be regained. And there are reasonable grounds to think that an agreement can be found as both the US and Iran have incentives to end this conflict. President Trump faces the mid-term elections in November and therefore wants a quick resolution. He is likely to lose the House of Representatives where the Republicans only have a 3-seat majority, but if he loses the Senate as well then in his last two years, he will become a lame duck President and could face impeachment charges from a hostile Congress. On Iran's side they are suffering from hyperinflation and their currency has completely collapsed. These conditions usually lead to civil war. If a resolution can be found, then the oil price can return to half its current price. In that event the global economy which has taken a knock can regain momentum from the fiscal stimulus taking place in the US, Germany and Japan, and China's export boom. The outlook for commodities already had strong foundations due to the build out of datacentres for the AI boom and need to upgrade the electricity grid. The Middle East crisis only reinforces that as the world realises that it needs to build more robust and resilient access to critical commodities, and commodity prices are likely to stay high as countries build stockpiles to avoid future shortages as a result of the current shock.

Markets are at an unusual junction where the outcome will be determined by a resolution or otherwise in the Middle East. The longer the situation endures the worse the economy will be damaged as the supply of goods and materials runs low. Electoral pressures in the US and survival bias in Iran, together with pressure from countries like China who favour orderly global trade, makes a strong argument that some form of resolution should happen. In addition, at least in the US, it is also likely that the Federal Reserve will stimulate the economy with liquidity ahead of the midterm elections if the economy weakens. However as long as the impasse persists in the Straits of Hormuz uncertainty will hang over all markets.